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Business Expenses

For use in preparing
1985 Returns

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About This Book

This publication looks at a number of common business expenses and explains what is and what is not deductible. However, it does not cover every kind of deductible expense. For information on other business deductions, you may want to consult these separate IRS publications:

Publication 463, *Travel, Entertainment, and Gift Expenses*
Publication 534, *Depreciation*
Publication 539, *Employment Taxes*
Publication 549, *Condemnations and Business Casualties and Thefts*
Publication 548, *Deduction for Bad Debts*
Publication 587, *Business Use of Your Home*
Publication 916, *Information Returns*

The general rules for deducting business expenses are discussed in the opening chapter. The chapters that follow examine particular kinds of business expenses. Included are chapters on the deductions for amortization and depletion, and a chapter on expenses that you can choose either to deduct or to capitalize.

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Chap

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1. Deducting Business Expenses

Business expenses are the normal and current costs of carrying on a trade, business, or profession. These expenses are usually deductible, provided that the business is operated to make a profit.

The general rules for deducting business expenses are given in this chapter. These rules apply to every type of business expense, both those discussed here and those discussed in other publications. They cover the kinds of expenses you can deduct, the year in which you can deduct them, and the limits on how much can be deducted.

It is important for you to distinguish costs that are capital expenditures from costs that are deductible expenses. Otherwise, you may be required to capitalize the entire amount spent, even if part of it may be deductible as an expense.

What Can Be Deducted?

To be deductible, a business expense must be both ordinary and necessary. An ***ordinary*** expense is one that is common and accepted in your field of business, trade, or profession. A ***necessary*** expense is one that is helpful and appropriate for your trade, business, or profession. An expense does not have to be indispensible to be considered necessary.

It is important to separate business expenses from:

1) The expenses used to figure the cost of goods sold, and
2) Capital expenditures.

In addition, business expenses must be kept separate from personal expenses. If you have an expense that is partly for business and partly personal, you must divide the personal part from the business part.

Cost of goods sold. If your business manufactures products or purchases them for resale, some of your expenses are for the products you sell. These expenses are used to figure the cost of the goods you sold during the year. Cost of goods sold is subtracted from the total amount your business takes in to figure its gross profit for the year.

Among the expenses that go into figuring cost of goods sold are the following:

The cost of products or raw materials in your inventory, including the cost of having them shipped to you,

The cost of storing the products you sell,

Direct labor costs for workers who produce the products,

Depreciation on machinery used to produce the products, and

Factory overhead expenses.

If an expense is used to figure cost of goods sold, it cannot be deducted again as a business expense.

Capital expenditures. Some costs must be capitalized rather than deducted. These costs are considered a part of your investment in your business and are called "capital expenditures." There are, in general, three types of costs that must be capitalized:

1) ***Going into business.*** The costs of getting started in business, before you actually begin business operations, are all capital expenditures. This may include expenses for such things as advertising, travel, utilities, repairs, or employees' wages. These are often the same kinds of costs that can be deducted when you have them after you open for business.
2) ***Business assets.*** What you spend for any asset that you will use in your business for more than one year is a capital expenditure. There are many different kinds of business assets—such as land, buildings, machinery, furniture, trucks, patents, and franchise rights. You must capitalize the full cost of the asset, including freight and installation charges.
3) ***Improvements.*** The cost of making improvements to a business asset are also capital expenditures, if the improvements add to the value of the asset, appreciably lengthen the time you can use it, or adapt it to a different use. Ordinarily, the cost of the improvement is added to the basis of the improved property.

Examples of improvements are new electric wiring, a new roof, a new floor, new plumbing, bricking up windows to strengthen a wall, and lighting improvements.

The cost of reconditioning, improving, or altering your property as part of a general restoration plan to make it suitable for your business must be capitalized. This applies even if some of the work would by itself be classified as repairs.

When you make a capital expenditure, it becomes a part of your "basis" in your business and its assets. Basis is a way of measuring your investment in an asset for tax purposes. Among other things, it is used to figure depreciation deductions, casualty losses, and gain or loss on an eventual sale of the asset. See Publication 551, *Basis of Assets*, for information on how to figure basis.

Although you generally cannot directly deduct a capital expenditure, you may be able to take deductions for the amount you spend through a method of depreciation, amortization, or depletion. These methods allow you to deduct a part of basis each year over a number of years. In this way you are able to "recover" your capital expenditure. See *Amortization* (Chapter 9) and *Depletion* (Chapter 10) in this publication. For information on depreciation, see Publication 534, *Depreciation*.

Replacements. Like the cost of improvements, you may not deduct the cost of a replacement that stops deterioration and adds to the life of your property. It should be capitalized and depreciated.

Amounts you pay to replace parts of a machine that only keep it in a normal operating condition are treated like repairs and are deductible business expenses. However, if your equipment has a major overhaul the expense is capitalized and depreciated.

Capital expenditures or deductible expenses. To help you distinguish between capital expenditures and deductible expenses, several different items are discussed below.

Business motor vehicles. The cost of a motor vehicle you buy to use in your business is usually capitalized. You can recover its cost through annual deductions for depreciation.

For passenger automobiles placed in service after June 18, 1984, there are dollar limits on the amount of depreciation you may claim each year. See Publication 534.

Repairs you make to your business vehicle are deductible. However, amounts you pay for reconditioning and overhaul of business vehicles are capital expenditures.

Roads and driveways. The cost of building a private road on your business property and the cost of replacing a gravel driveway with a concrete one are capital expenditures that you may be able to depreciate. The cost of maintaining a private road on your business property is deductible as an ordinary and necessary business expense.

Tools. Amounts spent for tools used in your business are deductible expenses if the tools wear out and are thrown away within one year from the date of purchase.

Machinery. The cost of replacing short-lived parts of a machine to keep it in good working condition and not to add to its life is deductible as an ordinary and necessary expense.

Heating equipment. The cost of changing from one heating system to another is a capital expenditure and not a deductible expense.

Carrying charges. You may have to pay taxes, interest, or other carrying charges because of construction improvements on your business property or because you purchase, transport, or install machines or fixed assets. You may choose to treat the expenses as capital expenditures rather than as current expenses. See Chapter 8.

Personal and business expenses. If you have an expense for something that is used partly for business and partly for personal purposes, you must divide the total cost between the business part and the personal part. You may deduct as a business expense only the part that is for business.

For example, if you borrow money and use 70% of it in your business and the other 30% for a family vacation, you may deduct as a business expense only 70% of the interest you pay on the loan. The remaining 30% may be deducted on Schedule A (Form 1040) if you itemize your deductions.

For certain property placed in service or leased after June 18, 1984, there are limits on the depreciation deductions (a "substantially equivalent" limitation applies to lessees of certain leased property) you may claim for property that you do not use predominantely (more than 50%) in a trade or business. See Publication 534.

Business use of your home. If you use your home in your business, this same rule applies to the expenses of maintaining your home—for example, mortgage interest, insurance, utilities, and repairs. You must divide the business part of these expenses from the personal part.

However, the business use of your home must meet some strict requirements before any of these expenses can be taken as business deductions. In general, you can deduct expenses only for the part of your home that you use both ***regularly*** and ***exclusively*** as either:

1) A place where you meet with customers or clients, or
2) The principal place where you carry on the business.

If you use your home as a day-care center or to store the products you sell, an exception may be made to the requirement that you must use a part of your home exclusively for business. For more information, see Publication 587, *Business Use of Your Home*.

Business use of your car. If you use your personal car in your business, you must determine how many miles you drove it for business out of the total mileage it was driven during the year. Only your expenses for the miles you drove it for business are deductible as business expenses. These expenses include depreciation on the car, gas and oil, tires, repairs, tune-ups, insurance, and registration fees. Instead of figuring the business portion of these expenses, you may be able to use a standard mileage rate to figure your deduction. The business part of interest on your car loan, state and local property tax on the car, parking fees, and tolls can be deducted in addition to the standard mileage rate. The nonbusiness part of interest and taxes may be deducted on Schedule A (Form 1040) if you itemize your deductions.

For passenger automobiles placed in service or leased after June 18, 1984, there are limits on the investment credit and depreciation deductions (a "substantially equivalent" limitation applies to lessees of leased automobiles) you may claim for the passenger automobile.

For more information on car expenses and the standard mileage rate, see Publication 463, *Travel, Entertainment, and Gift Expenses*.

Nondeductible expenses. Some business expenses are not deductible or are deductible in certain circumstances but not in others. The discussions in each of the chapters explain which expenses can be deducted and which cannot.

Recovery of amount deducted. If you are a cash method taxpayer who pays an expense and then recovers any part of the amount paid in the same tax year, reduce your expense deduction by the amount of the recovery. If you have a recovery in a later year, include the recovered amount in income. However, if part of the deduction for the expense did not reduce your income subject to tax, you do not have to include all of the recovery in income. Exclude an amount equal to the part that did not reduce your income subject to tax.

How Much Can Be Deducted?

You cannot deduct more for a business expense than the amount you actually spend. There is usually no other limit on how much you can deduct, provided that the amount is reasonable. However, if your deductions are large enough to produce a net business loss for the year, the amount of tax loss may be limited.

Limits on losses. If your deductions for an investment or business endeavor are more than the income it brings in, you have a net loss. There may be limits on how much, if any, of the loss you can use to offset income from other sources.

1) ***Not-for-profit limits.*** If you do not carry on your business activity with the intention of making a profit, you cannot use a loss from it to offset other income. The kinds of deductions you can take for a not-for-profit activity and the amounts you can deduct are limited so that a deductible loss will not result.
2) ***At-risk limits.*** In general, a deductible loss from a business or investment activity is limited to the amount of investment you have "at risk" in the activity. You are considered "at risk" for any of your own money you have invested. You are generally also considered "at risk" for amounts you have borrowed to invest, provided that you are personally liable for repayment of the loan or the loan is secured by property not used in the business.

For more information on the at-risk rules, see Publication 536, *Net Operating Losses and the At-Risk Limits*. The not-for-profit rules are discussed later in this chapter.

If you have a deductible loss that is more than enough to offset all your income for the year, you may have a "net operating loss." A net operating loss can be used to lower your taxes in other years. See Publication 536 for more information.

Payments in kind. If you provide services to pay a business expense, the amount you can deduct is limited to the amount you must spend to provide the services. It is not what you would have had to pay in cash.

Similarly, if you pay a business expense in goods or other property, you can deduct only the amount the property costs you. If these costs are already figured into the cost of goods sold, you may not deduct them separately as business expense.

When Can an Expense Be Deducted?

Under the cash method of accounting, business expenses are deducted in the tax year they are actually paid, even if they were incurred in an earlier year. Under the accrual method of accounting, business expenses are deductible when you become liable for them whether or not you pay them in the same

All events that set the amount of the liability must have happened, and you must be able to figure the amount of the expense with reasonable accuracy.

Economic performance rule. Business expenses are generally not deductible until economic performance occurs. If your expense is for property or services provided to you, or for use of property by you, economic performance occurs as the property or services are provided, or as the property is used. If your expense is for property or services that you provide to others, economic performance occurs as you provide the property or service.

Example. Your tax year is the calendar year. In December 1985, the Field Plumbing Company did some repair work at your place of business. They sent you a bill for $150, which you paid by check in January 1986. If you use the accrual method of accounting, you should deduct the $150 on your tax return for 1985 because all events that set the amount of liability and economic performance occurred in that year. If you use the cash method of accounting, you should take the deduction on your 1986 return.

For more information on methods of accounting, see Publication 538, *Accounting Periods and Methods.*

Prepayment. Expenses paid in advance cannot be deducted in advance, under either the cash or the accrual method. For example, suppose you sign a 10-year lease and immediately pay your rent for the first 3 years. Even though you paid the rent in advance, you can deduct only the rent for your current tax year. You must wait until next year and the year after to deduct the rent for those years. The same rule applies to prepaid interest, prepaid insurance premiums, and any other expense that is paid far enough in advance to, in effect, create an asset extending substantially beyond the end of the current tax year.

Contested liabilities. Under the cash method, you deduct a disputed expense just as you would any other expense—only in the year you pay it.

However, a special rule applies under the accrual method if you choose to contest whether you are liable for an expense. You do not deduct the expense in the year that it is incurred. Rather, you deduct it in the earlier of the following 2 years:

1) The year the dispute is settled and you are found to be liable, or
2) The year that you pay the expense or transfer funds to pay it—for example, to an escrow account not under your control.

If later, after the dispute is settled, any of your payment is returned to you, you must report it as income. However, if any part of the deduction did not reduce your income, you can subtract that amount from the returned payment before reporting it as income.

See Publication 538 for more information.

Related parties. Under the accrual method of accounting, you generally deduct expenses when you incur them, even if you have not yet paid them. However, if you and the person you owe are "related parties" and the person you owe uses the cash method of accounting, you are allowed a deduction only when you pay the expense. Thus, the deduction by an accrual method payor is allowed no earlier than when the corresponding amount is includible in income by the cash method payee.

For the definition of "related party" and a full discussion of this rule, see *Unpaid Salaries* in Chapter 2.

Not-for-Profit Activities

If your business activity or the activity you invest in is not carried on to make a profit, the deductions you can take for it are limited and no loss will be allowed to offset other income. Activities you do as a hobby, or mainly for sport or recreation, would come under this limit. So would an investment activity that is intended only to produce tax losses for the investors.

The limit on not-for-profit losses applies to individuals, partnerships, estates, trusts, and S corporations. It does not apply to corporations other than S corporations.

Not-for-profit. In determining whether or not an activity is carried on for profit, all the facts in regard to the activity are taken into account. No one factor alone is decisive. Among the factors to be considered are:

1) Whether you carry on the activity in a businesslike manner.
2) Whether the time and effort you put into the activity indicate you intend to make it profitable.
3) Whether you are depending on income from the activity for your livelihood.
4) Whether your losses from the activity are due to circumstances beyond your control (or are normal in the start-up phase of your type of business).
5) Whether you change your methods of operation in an attempt to improve the profitability of the activity.
6) Whether you, or your advisors, have the knowledge needed to carry on the activity as a successful business.
7) Whether you have been successful in making a profit in similar activities in the past.
8) Whether the activity makes a profit in some years, and how much profit it makes.
9) Whether you can expect to make a future profit from the appreciation of the assets used in the activity.

Limit on deductions and losses. If your activity is not carried on for profit, deductions are allowed only in the following order, only to the extent stated in the three categories, and only if you itemize them on Schedule A (Form 1040).

1) Deductions that you can take for personal as well as for business activities are allowed in full. All nonbusiness deductions, such as those for interest, taxes, and casualty losses belong in this category. Casualty losses are deductible as personal casualty losses to the extent each loss exceeds $100. Total personal casualty losses (in excess of $100 each) are deductible in full to the extent of personal casualty gains and any remaining loss is deductible to the extent it exceeds 10% of your adjusted gross income. See Publication 547, *Nonbusiness Disasters, Casualties, and Thefts.*
2) Deductions that do not result in an adjustment to the basis of property are allowed next, but only to the extent that your gross income from the activity is more than the deductions you take (or could take) for it under the first category. Most business deductions, such as those for advertising, insurance premiums, utilities, wages, etc., belong in this category.
3) Business deductions that decrease the basis of property are allowed last, but only to the extent that the gross income from the activity is more than deductions you take (or could take) for it under the first two categories. The deductions for depreciation, amortization, and the portion of a casualty loss not deductible in category (1) belong in this category. Where more than one asset is involved, depreciation and these other deductions must be divided proportionally among those assets.

Example. You are engaged in a not-for-profit activity. The income and expenses of the activity are as follows:

Gross income		$3,200
Less expenses:		
Real estate taxes	$700	
Interest on mortgage	900	
Insurance	400	
Utilities	700	
Maintenance	200	
Depreciation on automobile	600	
Depreciation on a machine	200	
Total expenses		3,700
Loss		$ 500

Your deductions are limited to $3,200, the amount of gross income you earned from the activity. The limit is reached in category (3), as follows:

Limit on deduction		$3,200
Category 1, Taxes and interest	$1,600	
Category 2, Insurance, utilities, and maintenance	1,300	2,900
Available for Category 3		$ 300

The $300 for depreciation is divided between the automobile and the machine, as follows:

$\frac{\$600}{\$800} \times \$300 = \$225$ depreciation for the automobile

$\frac{\$200}{\$800} \times \$300 = \$75$ depreciation for the machine

The basis of each asset is reduced accordingly.

Partnerships and S corporations. If a partnership or S corporation carries on a not-for-profit activity, these limits apply at the partnership or S corporation level. They are reflected in the individual stockholder's or partner's distributive shares.

More than one activity. A single business or investment activity may consist of more than one undertaking, if they are similar or serve the same business purpose and are organizationally connected, or different undertakings may be considered to be different activities. If you are in fact carrying on two or more different activities, you must keep the deductions and income from each one separate. Figure separately whether each one is a not-for-profit activity. Then figure the limit on deductions and losses separately for each activity that is not-for-profit.

Presumption that an activity is for profit. An activity is presumed to be carried on for profit if it produced a profit in at least 2 of the last 5 tax years including the current year. Activities that consist primarily of breeding, training, showing, or racing horses are given extra time to produce 2 years of profit. They are presumed to be carried on for profit if they produced a profit in at least 2 out of the last 7 tax years. You have a profit when the gross income from an activity is more than the deductions attributable to it.

If a taxpayer dies before the end of the 5 year (or 7 year) period, the period is considered to have ended on the date of the taxpayer's death.

If your business or investment activity passes this 2-years-of-profit test, it is presumed to be carried on for profit. This means that it will not come under the limits discussed here. You can take all of your business deductions from the activity, even for the years that you have a loss.

You can rely on this presumption in every case, unless the Internal Revenue Service shows it is not valid.

Using the presumption at a later time. If you are starting out in an activity and you do not yet have 2 years showing a profit, you may want to take advantage of this presumption at a later time, after you have had the 5 (or 7) years of experience allowed by the test.

You can choose to do this by filing Form 5213, *Election to Postpone Determination.* Filing this form postpones any determination that your activity is not carried on for profit until 5 (or 7) years have passed since you first started the activity. Form 5213 must be filed within 3 years of the due date of your return for the year in which you first carried on the activity.

The benefit gained by making this choice is that the Internal Revenue Service will not immediately question whether your activity is engaged in for profit. Accordingly, it will not restrict your deductions. Rather, you will gain time to earn a profit in 2 out of the first 5 (or 7) years you carry on the activity. If you show 2 years of profit at the end of this period, your deductions will not be limited under these rules. If you do not have 2 years of profit, the limit will be applied retroactively to any year in the 5 year (or 7 year) period that you had a loss.

Filing Form 5213 automatically extends the statute of limitations on any year in the 5 year (or 7 year) period to 2 years after the due date of the return for the last year in the period. The statute is extended only for deductions attributable to the activity and any related deductions that might be affected.

2. Employees' Pay

Salaries, wages, and other forms of pay you make to employees may be deductible business expenses. However, any deduction taken for salaries and wages must be reduced by the dollar amount of any targeted jobs credit allowable for the tax year. For more information, see Publication 906, *Jobs and Research Credits.*

To be deductible, employees' pay must meet the following four tests.

Test 1.—Ordinary and necessary. You must be able to show that salaries, wages, and other payments for employees' services are ordinary and necessary expenditures directly connected with or pertaining to your trade or business.

The fact that you pay your employees reasonable amounts for a legitimate business purpose is not sufficient, by itself, to qualify the amounts you pay them as deductible business expenses. You may deduct remuneration for services only if the payments are ordinary and necessary expenses of carrying on your trade or business.

Expenses (including salaries and other payments for services) incurred in completing mergers, recapitalizations, consolidations, and other reorganizations are not expenses of carrying on a business; they are capital expenditures, which are not deductible as ordinary and necessary business expenses. However, if you later abandon the plan to reorganize, you may deduct the expenditures related to the plan in the year abandoned.

Similarly, salaries and other expenses incurred in connection with the construction of capital assets, including salaries of employees attributable to the construction, are not deductible as business expenses. Rather, they are included in the basis of the constructed asset, and may be recovered through depreciation allowances over the asset's useful life (or recovery period if the asset is recovery property). See Publication 534, *Depreciation.*

Test 2.—Reasonable. What is reasonable pay is determined by the facts in each case. Generally, it is the amount that normally would be paid for similar services by like enterprises under similar circumstances.

You must be able to prove that the pay is reasonable. This is based on the circumstances that exist at the time you contract for the services, not those existing when the reasonableness is questioned.

If pay is excessive, only the part that is reasonable will be deductible.

Factors to be considered. These factors and all other pertinent data must be considered in determining whether pay is reasonable:

1) Duties performed by the employee,
2) Volume of business handled,
3) Character and amount of responsibility,
4) Complexities of the business,
5) Amount of time required,
6) General cost of living in the locality,
7) Ability and achievements of the individual performing the service,
8) Comparison of the pay with the amount of gross and net income of the business, as well as distributions to shareholders,
9) Taxpayer's pay policy as to all of its employees, and
10) Pay history of each employee.

Individual salaries. The test of reasonableness is based on each individual's salary and the service performed rather than on the total of salaries paid to all officers or employees.

Example. The Marshall Corporation paid $100,000 total salaries to its officers, a reasonable amount considering all the factors. But, of this, $75,000 was paid to the president, whose services were inconsequential. Since the pay was excessive for the services performed, the salary would not be considered reasonable even though the total amount of officers' salaries was reasonable.

Test 3.—Services rendered. You must be able to prove that the payments were made for services actually rendered, and you must reasonably expect your business to benefit from the services performed. These services need not be performed during the tax year. However, the pay claimed as a deduction for past services must be actually paid or incurred during the tax year.

Test 4.—Paid or incurred. You must have actually made the payments or incurred the expense during the tax year.

If you use the cash receipts and disbursements method of accounting, the deduction for salaries and wages is allowable only in the year paid.

If you use an accrual method of accounting, the deduction for salaries and wages is allowable when the obligation to make the payments is established and economic performance occurs (generally, as an employee renders his or her services to you). The economic performance rule is discussed under *When Can an Expense Be Deducted?* in Chapter 1. The payments need not be made in the year the obligation exists but may be deferred to some later date. However, see *Unpaid Salaries,* later in this chapter.

Bonuses. Bonuses you pay to employees are allowable deductions if they are intended as additional pay for services, not gifts, and are paid for services actually rendered. When bonuses are added to the regular salaries and other pay, the total must not exceed reasonable payment for the services rendered. The bonuses may be paid in cash, in property, or in a combination of both.

Gifts. If in order to promote employee goodwill, you distribute turkeys, hams, or other items of merchandise of nominal value at Christmas or other comparable holidays to your employees, the value of these items is not considered salary or wages for purposes of social security taxes (FICA), federal unemployment taxes (FUTA), or income tax withholding. The value is excludable from your employees' gross incomes, but you may still deduct the cost of these items as a business expense.

The cost of gifts you make to your employees may be deductible, but there is a $25 annual limit on the deduction for gifts to any one individual. However, different limits apply to certain awards you make to your employees for length of service, productivity, or safety achievement.

If you distribute cash, gift certificates, or similar items of readily convertible cash value, the value of such items is considered additional wages or salaries, regardless of the amount. For more information about gifts or awards you make to your employees, see Publication 463, *Travel, Entertainment, and Gift Expenses.*

Part of cost of goods sold. Mining and manufacturing concerns take most of the salaries, wages, or other compensatory expenses into account as part of cost of goods sold. They may not deduct such items again as business expenses.

Employee-stockholders. Salaries of employee-stockholders must meet the same rules for deductibility as those of any other executive or employee. If the corporation uses an accrual method and the salary is unpaid at the end of the tax year, see *Unpaid Salaries,* later in this chapter.

The burden of proving that the payments to employee-stockholders are reasonable and are for personal services actually rendered is somewhat greater than in the case of payments to executives or employees who have little or no ownership interest in the corporation.

Payments to employee-stockholders that are not for services rendered may not be deductible. The payments may instead be distributions of dividends on stock. This is most likely to occur in a corporation with few shareholders, practically all of whom draw salaries. If the salaries of employee-stockholders exceed those ordinarily paid for similar services, and particularly if the excessive payments bear close relationships to the stockholdings of the officers or employees, the salaries probably are not paid wholly for services rendered and include distributions of earnings on the stock.

However, if the payments to a shareholder-employee of a closely held corporation are reasonable for the services performed, a deduction will not be denied merely because the corporation has a poor history of paying dividends on its outstanding stock.

Loans and advances. Loans and advances you make to an employee that you do not expect the employee to repay generally are deductible if they are for personal services actually rendered, the total is reasonable when they are added to the employee's other compensation, and they meet all the other requirements for deductibility, discussed earlier.

Closely-held corporation. If a loan or advance is made to an officer-stockholder without expectation of recovery, it will not be deductible unless you can show clearly that it was not intended as a dividend and that it meets all the requirements for deductibility as compensation.

Below-market interest rate loans. In certain loans you make to an employee or stockholder you may be considered as having received interest income and having paid compensation or dividends equal to that interest. See *Below-Market Interest Rate Loans in Chapter 5 for additional information.*

yments to a beneficiary of a deceased em-oyee. Payments you make (whether in a lump m or otherwise) to an employee's beneficiary cause of the employee's death are deductible the total paid is reasonable in relation to past rvices performed by the employee and they herwise meet the tests for deductibility. The neficiary must include the payments in in-me to the extent that they exceed the $5,000 ath-benefit exclusion. For more information, e Publication 575, *Pension and Annuity In-me.*

latives. You may deduct salaries and wages id to employees who are your relatives, in-uding your minor child, if the four tests for ductibility are met in their employment. How-er, see *Unpaid Salaries*, later in this chapter.

elf-Insured Medical eimbursement Plans

In general, employers may deduct amounts id under a self-insured medical reimburse-ent plan to reimburse employees for medical penses. These amounts are not included in e employees' gross incomes and are not sub-ct to FICA, FUTA, or income tax withholding.

A self-insured medical reimbursement plan is n employer's written plan that reimburses em-oyees for medical expenses that are not reim-rsed by an accident and health insurance olicy. The medical expenses can be for the mployees, their spouses, or their dependents.

If a plan discriminates in favor of highly paid dividuals, all or a part of the amounts paid to ese highly paid individuals must be included their gross incomes as an excess reimburse-ent. Benefits paid to participants who are not ghly paid individuals may be excluded from oss income even if the plan is discriminatory, they meet the usual requirements for exclu-on from gross income.

ighly paid individuals. For purposes of this scussion, a highly paid individual is an indi-dual who is:

- One of the five highest paid officers,
- A shareholder who owns directly or in-directly more than 10% in value of the em-ployer's stock, or
- Among the highest paid 25% of all employ-ees. To determine this amount, include the five highest paid officers, but do not include employees who may be excluded.

Employees who may be excluded. Employees ay be excluded from the plan if they fall into ne of the following categories:

- Employees who have not completed 3 con-secutive years of service before the start of the plan year.
- Employees who have not reached age 25 before the start of the plan year.
- Part-time employees (generally those work-ing less than 35 hours per week) and sea-sonal employees (generally those working less than 9 months of the year).
- Employees who are members of a collective bargaining unit for which the accident and health benefits, if any, were the subject of good-faith bargaining.
- Employees who are nonresident aliens and receive from the employer no earned income from sources within the United States.

Accrual of Vacation Pay

If you use the accrual method of accounting, ou may elect to deduct a reasonable amount dded to a vacation pay accrual account if the mount represents your liability for vacation ay earned by employees before the end of the current tax year and expected to be paid no later than 12 months after the end of the current tax year. In addition, you may deduct the amount of any reduction in the suspense account at the end of the current tax year. See *Suspense account*, below.

All vacation payments must be charged to the vacation pay accrual account. Amounts are considered payable no later than 12 months after the close of the current tax year if your employees have the right to receive the payments during that period, even though payments actually are made after the period.

Vacation pay accrual account. The opening balance for the first tax year for which you choose to deduct additions to the vacation pay accrual account is an amount equal to the largest closing balance you would have had for any of your 3 tax years immediately before the first year in which you used this method. The balance is figured as if you had kept an account in that year.

However, if you were allowed a deduction for vested accrued vacation pay for your last tax year ending before July 18, 1984, and you make this choice for your first tax year ending after July 18, 1984, your opening balance is figured differently. Your opening balance for your first tax year ending after July 18, 1984, is the same amount your closing balance would have been for the preceding tax year had you maintained a vacation pay accrual account for the preceding year.

Suspense account. Allowance of a deduction for a vacation pay accrual account requires that you have a suspense account at the start of the first tax year in which you keep such an account. The opening balance of the suspense account is the same as the opening balance of the vacation pay accrual account. This opening balance is reduced by the amount, if any, allowed as deductions for prior tax years for vacation pay accrued but not paid at the end of the tax year preceding the tax year in which you first used this method.

At the end of each tax year, the suspense account must be reduced by the excess of the amount in the account at the start of the year over the amount in the vacation pay accrual account at the end of the year. The amount of the reduction is a deduction from gross income. The suspense account must be increased by the excess of the amount in the vacation pay accrual account at the end of the year over the amount in the suspense account at the start of the year, but not in excess of the original account balance. The amount of the increase in the suspense account is included in gross income.

Unpaid Salaries

If you have a definite, fixed, and unconditional agreement to pay your employees a certain salary for a year but you defer payment of part of it until the next tax year, then under the accrual method of accounting the entire salary is deductible in the first year if economic performance occurred (the employees rendered their services to you in that year). Under the cash method, only the amount actually paid in each year is deductible in that year.

If no definite prior arrangement was made, only the amount paid in the first year is deductible in that year because no fixed obligation existed to make later payments. This result is the same for the cash method and the accrual method.

A special rule for an accrual method payer. This rule governs the deduction for salaries, wages, and other business expenses if you and the person to be paid are related taxpayers.

Under this rule, you, an accrual basis payer, cannot deduct salaries, wages, and other expenses owed to a related cash basis employee (or other payee), until the tax year in which the payment is made and the amount is includible in the gross income of the person paid. This rule will apply even if prior to the time the amount is includible in the gross income of the person to whom payment is to be made, the person and the payor cease to be related taxpayers. Related taxpayers are defined later.

Example 1. Tom Green runs a retail store as a sole proprietor. He uses an accrual method and the calendar year. He employs his brother Bob for the salary of $1,000 a month. Bob uses the calendar year cash method. At the end of December 1985, Tom accrues the $1,000 December salary.

Because of a temporary cash shortage, $600 is paid to Bob on January 14, 1986, and the $400 balance is paid to him on April 1, 1986. Tom cannot deduct the $1,000 until 1986, the year Bob is required to include the amount in his income.

Example 2. The Lomar Corporation uses an accrual method and the calendar year. Frank Wilson, an officer in the corporation, uses the calendar year and the cash method. At the close of calendar year 1985, he owned 50% in value of the outstanding stock of the corporation. On March 4, 1986, he acquired additional shares that brought his holdings up to 51%. The corporation, at the end of December 1985, accrued $1,000 salary payable to Frank Wilson.

The Lomar Corporation paid Frank $600 on January 30, 1986, and the balance by March 14, 1986. The corporation is entitled to the $1,000 salary deduction in 1985. Frank and the Lomar Corporation were not related taxpayers at the close of Lomar's 1985 tax year.

Related taxpayers. For the purpose of applying the prior rules, related taxpayers include the following:

1) Members of the immediate family, including only brothers and sisters (either whole- or half-blood), husband and wife, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.);
2) Two corporations that are members of the same controlled group of corporations determined by applying a 50% ownership test;
3) The fiduciaries of two different trusts, and the fiduciary and beneficiary of two different trusts if the same person is the grantor of both trusts;
4) Certain educational or charitable organizations and a person who directly or indirectly controls the organization;
5) An individual and a corporation of which more than 50% of the value of the outstanding stock is owned directly or indirectly by or for that individual;
6) A trust fiduciary and a corporation of which more than 50% in value of the outstanding stock is owned directly or indirectly by or for the trust or by or for the grantor of the trust;
7) The grantor and fiduciary, and the fiduciary and beneficiary, of any trust;
8) A corporation and a partnership if the same persons own over 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest or the profits interest in the partnership;
9) Two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation; and
10) An S corporation and a regular corporation if the same person owns more than 50% in

value of the outstanding stock of each corporation.

Somewhat different rules apply to unpaid expenses of S corporations. For information on these rules, see Publication 589, *Tax Information on S Corporations*.

Indirect ownership of stock. In determining whether a person indirectly owns any of the outstanding stock of a corporation, the following rules apply:

1) Stock owned directly or indirectly by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries;
2) Stock owned directly or indirectly by or for an individual's family is considered owned by the individual. (The family of an individual includes only brothers and sisters (whole- or half-blood), spouse, ancestors, and lineal descendants.);
3) Any stock in a corporation owned by an individual (other than by applying rule (2)) is considered owned by or for the individual's partner; and
4) Stock considered owned by a person under rule (1) is, for applying rules (1), (2), or (3), treated as actually owned by that person. But stock considered owned by an individual under rules (2) or (3) is not treated as owned by that individual for the purpose of again applying either rule (2) or (3) to consider another the owner of that stock.

Reallocation of income and deductions. If it is necessary, to clearly reflect income or to prevent evasion of taxes, the Internal Revenue Service may reallocate gross income, deductions, credits, or allowances between two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

Meals and Lodging

You may deduct only the cost to you of meals, lodging, and inventoriable items furnished to your employees as part of their pay. If you have deducted the cost of these items elsewhere, for example, as part of the cost of goods sold, you may not deduct their cost again as pay for your employees.

A sole proprietor is not an employee of a proprietorship, and a partner is not an employee of a partnership in considering the following rules for meals and lodging. Meals and lodging expenses of a sole proprietor or a partner are personal and are nondeductible expenses of the individual receiving the meals and lodging. Also, such expenses are ***not deductible*** by the proprietorship or partnership.

Although you may deduct only your ***cost*** of the meals and lodging furnished to your employees, your employees (for purposes of this discussion, the term employee includes the employee's spouse and any of the employee's dependents) may have to include in gross income the ***value*** of meals and lodging furnished by you.

Tests. To enable employees to exclude from their gross income the value of meals and lodging furnished them without charge by the employer, the following tests must be met:

1) The meals or lodging must be furnished on the employer's business premises;
2) The meals or lodging must be furnished for the employer's convenience; and
3) In the case of lodging (but not meals), the employees must be required to accept it as a condition of their employment. This means that acceptance of the lodging is required to enable them to properly perform the duties of their employment, as when they must be available for duty at all times.

Business premises of the employer generally means the place of employment. For example, meals and lodging furnished to a domestic servant in a private home are furnished on the business premises of the employer. Similarly, meals furnished to cowhands while herding their employer's cattle on land leased or owned by the employer are furnished on the business premises of the employer.

Convenience of the employer. Whether meals or lodging are furnished for the convenience of the employer must be determined from all the relevant facts and circumstances. Meals or lodging furnished by an employer will be considered furnished for the employer's convenience if the employer has some substantial business reason other than merely providing additional pay. A mere statement that the meals or lodging are not intended as pay is not sufficient to establish that either meals or lodging are furnished for the convenience of the employer.

If an employer has a substantial nonpay business reason for furnishing meals or lodging, and these items are furnished on the business premises (and in the case of lodging, *Test (3)* is also met), their value is not includible in the employees' income, even though the employer may intend them to be pay. Thus, the value of meals or lodging may be excludable from the employees' income even if a statute or the employment contract provides that they are furnished as pay. Conversely, if meals or lodging are furnished by an employer as a means of providing additional pay, and the employer does not have a substantial nonpay business reason for furnishing them, their value is additional income to the employees.

Meals furnished without charge. Following are some situations under which meals furnished without charge by an employer will be regarded as furnished for a substantial nonpay business reason. If they are furnished on the employer's business premises, their value is not includible in the employee's income:

1) Meals furnished during the working hours so that the employee will be available for emergency calls during the meal period. (However, it must be shown that emergencies have actually occurred or reasonably can be expected to occur, resulting in the employer's calling upon the employee to perform the duties of the employee's job during the meal period.);
2) Meals furnished during working hours because the nature of the employer's business restricts the employee to a short meal period (such as 30 or 45 minutes), and the employee cannot be expected to eat elsewhere in such a short time. (For example, meals may qualify if there are insufficient eating facilities near the place of employment, or if the peak workload occurs during the normal lunch hour. But if the reason for the short meal period is to allow the employee to leave earlier in the day, the meal will not qualify.);
3) Meals furnished to restaurant employees, or other food service employees, for each meal period in which they work, whether the meals are furnished during, immediately before, or immediately after working hours. (Thus, if a waitress works through the breakfast and lunch periods, she may exclude from income the value of breakfast and lunch furnished in her employer's restaurant for each day she works.);
4) Meals furnished after working hours that would have been furnished during work hours for the convenience of the employer, but because of the work duties were not eaten during the working hours; and
5) Meals furnished to employees, at the employer's place of business if substantially all of the employees are furnished meals for a substantial nonpay reason of the employer.

Meals furnished with a charge. If the employer provides meals that the employees may choose to purchase or not purchase, the meals are not to be considered as furnished for the convenience of the employer.

If the employer furnishes meals for which the employees are charged an unvarying flat amount, the ***flat charge*** is not included in the employee's income. This is not dependent on the employees' acceptance of the meals.

The ***actual value of the meals*** may be included in their incomes depending upon whether *Tests (1) and (2)* are met.

If an unvarying flat amount is charged for meals and the value of the meals is determined to be additional income, the value must be included in the employees' income regardless of whether it is more or less than the amount charged. In the absence of evidence indicating otherwise, the value of the meals is the amount charged for them.

Meals furnished on nonworkdays or with lodging. The value of meals furnished by the employer on any nonworkday is normally income. But, if the employees are required to occupy living quarters on the employer's business premises as a condition of employment, as defined in *Test (3)*, the value of ***any*** meal furnished by the employer without charge on the business premises is ***not*** considered income.

Meals furnished to promote employee goodwill. If you furnish meals to your employees to promote their goodwill or morale or to attract prospective employees, the meals are considered to be pay. In the absence of a substantial nonpay business reason, the value of these meals is income to the employees.

Lodging furnished with or without a charge. If *Tests (1), (2),* and *(3)* are met, the value of lodging furnished is not includible in the employees' incomes whether it is furnished to the employees with or without a charge. Also, it is excludable even though the employment contract, or a statute fixing the terms of the employment, provides that the lodging is furnished as pay.

If an employer charges an unvarying amount for lodging whether or not the employee accepts it, the flat charge is not includible in the gross income of the employee. Whether the value of such lodging is income is dependent upon whether all of *Tests (1), (2),* and *(3)* are met. If any one of these tests is not met, the value of the lodging must be included in income, regardless of whether it is more or less than the amount charged. In the absence of evidence indicating otherwise, the value of the lodging may be considered equal to the amount charged for it.

If the employees have a choice of either additional pay or meals or lodging, the value of the meals or lodging is income. However, if the employees simply decline to accept the meals (and have no choice of additional pay), the value of the meals will not necessarily be income.

The examples that follow will help you determine whether the value of meals or lodging you furnished your employees must be included in their incomes.

Example 1 (Meals). Carol, a waitress who works from 7 a.m. to 4 p.m. is furnished, without charge, two meals per workday. The em-

ployer encourages (but does not require) Carol to have her breakfast on the business premises before starting work. She must have her lunch on the premises. Since Carol is a food service employee and works during the normal breakfast and lunch periods, the value of her breakfast and lunch is *not* income.

Example 2 (Meals). Carol is also allowed to have meals on her employer's premises without charge on her days off. The value of these meals *is* income.

Example 3 (Meals). Frank, a bank teller who works from 9 a.m. to 5 p.m., is furnished his lunch without charge in a cafeteria that the bank maintains on its premises. The bank furnishes Frank these meals to limit his lunch period to 30 minutes, since the bank's peak workload occurs during the normal lunch period. If Frank had to get his lunch elsewhere, it would take him considerably longer than 30 minutes, and the bank strictly enforces the time limit. The value of these meals is *not* income.

Example 4 (Meals). A hospital maintains a cafeteria on its premises where all its 230 employees may get meals at no charge during their working hours. The hospital furnishes meals to have each of 210 of the employees available for emergencies, and it is shown that each such employee is at times called upon to perform services during the meal period. Although the hospital does not require these employees to remain on the premises during meal periods, they rarely leave the hospital during their meal period. Since the hospital furnishes meals to substantially all its employees to have each of them available for emergency call during their meal periods, the value of the meals is *not* income to any of the employees who get their meals in the hospital cafeteria.

Example 5 (Meals and lodging). Bob, a construction worker, is employed at a remote job site in Alaska. Due to the inaccessibility of facilities and prevailing weather conditions, Bob and other employees working at the job site cannot get food and lodging. Thus, the employer is required to furnish meals and lodging to Bob at the camp site in order to carry on the construction project. Bob is required to pay $40 a week for the meals and lodging. Neither the weekly charge of $40 nor the value of the meals and lodging is includible in his income.

Example 6 (Lodging). Joan, an employee of an institution, is given the choice of living at the institution free of charge or living elsewhere and receiving a cash allowance in addition to her regular salary. If she elects to reside at the institution, the value of the lodging furnished Joan is income to her, because her residence at the institution is not required to properly perform the duties of her employment.

Payments in Kind and Fringe Benefits

You may pay your employees in cash or other property, such as meals, lodging, inventoriable items, capital assets, assets used in your business, and shares of stock in your company.

There are other forms of pay you may provide to your employees in an indirect way, such as insurance, hospitalization, and medical care. These forms of pay usually are referred to as fringe benefits. They are deductible as business expenses if they meet the requirements discussed in this publication and, with all other forms of pay, add up to a reasonable total.

Life insurance premiums. Life insurance premiums are not deductible if paid on any policy covering the life of an officer of a corporation, an employee, or any other person who has a financial interest in the employer's business if the employer is either directly or indirectly a beneficiary under the policy. In other words, if the employer rather than the employee is to get or have a right to the proceeds, the premiums are not deductible.

Premiums may be deductible if you can show that they represent current pay and that, when added to the employee's other pay, the total is reasonable. You also must show that only the employee or the designated beneficiaries, ***and not you,*** the employer, will benefit from the policy.

Group life insurance premiums paid or incurred by you on policies covering the lives of your officers and employees who designate their own beneficiaries are deductible if you do not retain any incidents of ownership, and if you are not directly or indirectly the beneficiary. This is true for both permanent group life and nonpermanent group life insurance. Under certain conditions, part of the premium payment on group term life insurance is included in the income of the employee.

Health insurance premiums. Group hospitalization and medical care premiums you pay for the benefit of your employees are deductible expenses. However, you may not deduct amounts paid or incurred for a health plan if the plan differentiates in the benefits it provides between individuals having end stage renal disease and other individuals covered by the plan on the basis of the existence of end stage renal disease, the need for renal dialysis, or in any other manner.

Medicare premiums for both active and retired employees also are deductible.

Wage continuation, accident, or health plans. Payments made under wage continuation, accident, or health plans to provide for payments to your employees while they are away from work because of sickness or injury are deductible expenses.

Education expenses. If you pay the tuition expenses of your employees who are enrolled in courses that are not required for their job or are not otherwise job related, you must treat these payments as wages. The payments are includible in income and are subject to FICA, FUTA, and income tax withholding.

Educational assistance programs. If you pay for tuition, fees, books, course supplies, and similar items for your employees under a qualified educational assistance program, the amounts paid are deductible but are not includible in the gross income of your employees (up to a certain amount). Employees are limited to an exclusion from gross income of up to $5,000 of the benefits they receive during a calendar year. Also, these payments are not subject to FICA, FUTA, or income tax withholding.

A qualified program:

1) Is a separate written plan of an employer for the exclusive benefit of the employees to give them educational assistance;
2) Cannot have eligibility requirements that discriminate in favor of officers, owners, or highly compensated employees or their dependents;
3) May not expend more than 5% of the amounts paid or incurred for educational assistance on a shareholder or owner (or their spouses or dependents) who (on any day of the year) owns more than 5% of the stock or of the capital or profits interest in the employer;
4) Must not provide eligible employees with a choice between educational assistance and other remuneration includible in gross income;
5) Need not be funded; and
6) Must provide for reasonable notification of the availability and the terms of the program to eligible employees.

Educational assistance means:

1) Payment (or reimbursement to the employee) by an employer of an employee's expenses that includes, but are not limited to, tuition, fees, books, supplies, and equipment, and
2) Courses provided by the employer for an employee, including any books, supplies, and equipment.

Educational assistance does not include any payment for, or provision of, tools or supplies, other than textbooks, that the employee can keep after completing the course. It also does not include meals, lodging, or transportation. Courses or other education involving sports, games, or hobbies do not qualify as educational assistance unless the education involves the business of the employer or is required as part of a degree program. The tax treatment provided for payments under educational assistance programs, discussed here, expire at the end of 1985. For information on the reporting requirements for educational assistance programs see the discussion under *Cafeteria plans*, later in this chapter.

Dependent care assistance programs. If you pay for or provide child care or disabled dependent care services for your employees to allow them to work, they can exclude the amounts you spend for these services from their gross incomes. In addition, the cost of providing the services is not subject to FICA, FUTA, or income tax withholding.

To qualify for this treatment the services must be provided under a plan that:

1) Is a separate written plan for the exclusive benefit of your employees to provide them with dependent care assistance;
2) Does not discriminate in favor of officers, owners, or highly paid employees;
3) Does not pay more than 25% of its benefits during the year for shareholders or owners (or their spouses or dependents). An owner is someone who owns (on any day of the year) more than 5% of the stock or of the capital or profits interest of the employer;
4) Provides reasonable notification of the availability and terms of the program to eligible employees; and
5) Furnishes to each employee by January 31 a written statement showing the amount the employer spent to provide dependent care assistance for the employee during the previous calendar year.

The amount an employee can exclude from gross income cannot be more than the employee's earned income. If the earned income of the employee's spouse is lower than the employee's, the amount that is excluded cannot be more than the spouse's earned income.

Commuter transportation. If you provide transportation in a commuter highway vehicle, such as a van or bus, for your employees (this does not include partners or self-employed individuals who meet the definition of employee for certain employee benefit (pension) plans), the value of the transportation is not includible in the income of the employees. The value of the transportation is also not subject to FICA, FUTA, or income tax withholding.

To qualify, the commuter highway vehicle must have a seating capacity of at least eight adults, not including the driver. In addition, you must reasonably expect that at least 80% of the vehicle's mileage will be used for transporting your employees between their residences and

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their places of employment on trips during which the number of employees transported is at least one-half of the adult seating capacity of the vehicle not including the driver. The mileage use not only includes mileage travelled on trips that transport the employees, but also mileage that is incidental to such trips, such as deadheading.

In determining whether the employees are transported from their homes to their places of employment, it is not necessary that the employees be picked up at and transported to their homes. It is sufficient if the employees are transported to and from some central point or points or intermediate location between the employees' residences and their places of employment.

There must be a separate written plan of the employer which does not discriminate in favor of employees who are officers, shareholders, or highly compensated employees. The plan must provide that the value of such transportation is in addition to, not in lieu of, any pay otherwise due to the employee. The plan must be in writing before the transportation is furnished.

Moving expenses. Payments to an employee as an allowance or reimbursement for the cost of moving to a new job site must be included in income, but are not considered wages for purposes of income tax withholding, FICA, or FUTA if it is reasonable to believe at the time payments are made that the employee will be allowed a deduction for moving expenses in computing income tax.

However, payments to an employee for expenses relating to the move that the employee may not deduct as a moving expense are considered wages for purposes of income tax withholding, FICA, and FUTA. For example, if you reimburse an employee for a loss on the sale of a residence, the amount paid is considered wages and is subject to income tax withholding, FICA, and FUTA. The reimbursements to an employee are considered payment for services and are deductible by you if the amounts meet the reasonable and necessary tests discussed earlier.

You are required to give your employees a statement detailing the payments made to or on behalf of your employees for moving expenses. You may use Form 4782, *Employee Moving Expense Information*. You must give this information to your employees no later than January 31 of the year following the year in which you make the payments.

Any reimbursement for moving expenses also must be shown in the totals on the employee's Form W–2, *Wage and Tax Statement*.

For more information on moving expenses, see Publication 521, *Moving Expenses*.

Supplemental unemployment benefits. Irrevocable contributions you make as an employer into an independently controlled trust fund, created solely to furnish supplemental unemployment benefits to your employees who qualify under this type of benefit plan as part of a collective bargaining agreement, are ordinary and necessary business expenses. You may deduct such amounts for the year in which they are paid or accrued, depending upon your method of accounting.

However, if there is no independently controlled trust fund and you make payments directly to qualifying former employees under a supplemental unemployment benefit plan, you may deduct the payments only for the year in which they are paid or in which your liability to particular employees becomes fixed, depending upon the method of accounting you use. In such a case, no deduction is allowable on the accrual method solely because you set aside funds in a special account or make a book entry.

Supplemental unemployment benefits paid to former employees are income when they receive them and are subject to income tax withholding. However, you need not withhold FICA or pay FUTA on payments to the trust fund or to former employees, even though the amounts paid to the former employees are income when they receive them.

Guaranteed annual wages. If you guarantee to pay certain designated employees full pay during the year (determined by the number of hours in your normal work year) under terms of a collective bargaining agreement, such payments are deductible as wages and are subject to FICA, FUTA, and income tax withholding.

Prepaid legal expenses. Payments made by you to a qualified group prepaid legal service plan, which provides legal services for an employee or an employee's spouse or dependent, are deductible. For tax years ending before 1986, any amount paid or the value of any services provided under this plan is not subject to FICA or FUTA and is not considered income to those individuals covered by the plan. For information on the reporting requirements for qualified group prepaid legal services plans, see the discussion under *Cafeteria plans* later in this chapter.

Compensation for injuries. Amounts you pay to employees because of injuries, including lump-sum amounts paid or accrued as compensation for injuries, are allowable deductions. They are limited to amounts not compensated for by insurance or otherwise.

Capital assets and assets used in your business. If you transfer a capital asset or an asset used in your business to one of your employees in payment for services, its fair market value on the date of the transfer is deductible as wages paid. The deductible amount is considered as received in exchange for the asset, and gain or loss is recognized on the transfer to the extent of the difference between the fair market value of the asset and its adjusted basis on the date of the transfer. The gain or loss has the same character that the asset transferred had in your hands.

Payments in stock. If you give stock in your company to your employees as pay, you are entitled to deduct the fair market value of the stock as of the date given. The employees are required to include this amount in their incomes.

Pay in the form of restricted property. In general, restricted property is property that is subject to a restriction that has a significant effect on its value.

If you transfer property to a person as payment for services and the property is considered substantially vested in that person, you generally are considered to have a deductible ordinary and necessary business expense. The amount deductible and the year in which it is deductible will vary, depending in part upon the kind of property interest that you transferred. The amount deductible depends on the amount includible in the recipient's income. However, if the recipient is an employee, you must withhold federal income tax in order to be entitled to take a deduction.

Cafeteria plans. Cafeteria plans are separate written plans that allow participants (who must be employees) to choose among two or more benefits consisting of cash and nontaxable benefits. A participant is not treated as having received a taxable benefit offered under a cafeteria plan solely because the participant has the opportunity, before the benefit becomes currently available, to choose among the taxable and nontaxable benefits offered under the plan.

Taxable and nontaxable benefits. The only taxable benefit that a cafeteria plan may offer is cash. A cafeteria plan may offer any nontaxab benefit other than scholarships and fellowshi grants, qualified vanpooling, educational assi ance programs, and the fringe benefits discussed later under *Exclusion of fringe benefits*.Nontaxable benefits will include grou term life insurance that is includible in gross i come only because the amount of the insurance exceeds $50,000 or the insurance is on the life of the employee's spouse or children.

Nondiscrimination rules. If, in any plan year a cafeteria plan discriminates in favor of highly compensated participants as to eligibility to pa ticipate in the plan or as to contributions or benefits, the highly compensated participant is taxed to the extent of the taxable benefits that could have been elected. The taxable benefits are treated as having been received or accrue in the tax year of the highly compensated participant in which the plan year ends.

A highly compensated participant is a partic pant who is:

1) An officer,
2) A shareholder owning more than 5% of the voting power or value of all classes of stock of the employer,
3) Highly compensated, or
4) A spouse or dependent of an individual described in items (1), (2), or (3) above.

If more than 25% of the total nontaxable benefits are provided to employees who are ke employees in the plan, then the key employees will be taxed as though they received all available taxable benefits under the cafeteria plan. The total nontaxable benefits that are provided to key employees are determined by coverage under a plan (such as an accident or health plan). The rules on highly compensated participants, discussed above, continue to apply in addition to the key employees rule.

Reporting requirements. Every employer that maintains a cafeteria plan is required to keep complete records and file a return for that year showing:

1) The number of employees of the employer,
2) The number of employees eligible to participate in the plan,
3) The number of employees participating under the plan,
4) The total cost of the plan for the tax year,
5) The name, address, and TIN of the employer, and
6) The type of business in which the employer is engaged.

Failure to file this return may result in a penalty of $25 for each day the return has not been filed, not to exceed $15,000. These reporting requirements apply equally to educational assistance programs and group legal services plans, both discussed earlier.

Taxable benefits chosen under a cafeteria plan are subject to FICA, FUTA, and income tax withholding. Generally, nontaxable benefits chosen under a cafeteria plan are not subject to FICA, FUTA, or income tax withholding.

Valuation and Taxation of Certain Fringe Benefits

Fringe benefits you provide in connection with the performance of services by a person are includible in the gross income of that person (the recipient, as defined later) as compensation for services unless specifically excluded. A person who refrains from performing services (such as under a covenant not to compete) is treated as performing services for purposes of these rules.

Some examples of these fringe benefits are:

1) An employer-provided automobile,
2) A flight on an employer-provided aircraft,
3) An employer-provided free or discounted commercial airline flight,
4) An employer-provided vacation,
5) An employer-provided discount on property or services,
6) An employer-provided membership in a country club or other social club, and
7) An employer-provided ticket to an entertainment or sporting event.

The **recipient** of a fringe benefit is the person performing the services in connection with which the fringe benefit is provided. Therefore, a person may be considered to be a recipient, even though that person did not actually receive the fringe benefit. For example, a fringe benefit provided to any person in connection with the performance of services by another person is considered to have been provided to the person who performs the services and not the person who receives the fringe benefit. In addition, if a fringe benefit is provided to a person, but is taxable to a second person as the recipient, the benefit is referred to as provided to the second person and use by the first person is considered use by the second person. The recipient of a fringe benefit does not have to be an employee of the provider of the fringe benefit, but may be a partner, director, or an independent contractor. In the following discussions, "employee" includes any recipient of a fringe benefit unless specified otherwise.

As the **provider** of a fringe benefit you are the person for whom the services are performed, regardless of whether you actually provide the fringe benefit to the recipient. You do not have to be the employer of the recipient of the fringe benefit, but may be, for example, a client or customer of an independent contractor.

These rules are effective as of January 1, 1985. No inference may be drawn from them concerning the application of law in effect prior to January 1, 1985.

Valuation of fringe benefits. An employee must include in gross income the amount by which the fair market value (FMV) of the fringe benefit exceeds the sum of (1) the amount, if any, paid for the benefit, and (2) the amount, if any, specifically excluded by law from gross income. Therefore, for example, if an employee who receives a fringe benefit pays FMV for what is received, no amount is includible in the gross income of the employee.

The **fair market value** (FMV) of a fringe benefit is generally determined on the basis of all the facts and circumstances. Specifically, the FMV of a fringe benefit is that amount a recipient would have to pay a third party to obtain (i.e., purchase or lease) the particular fringe benefit. Therefore, for example, the effect of any special relationship that may exist between you and the employee must be disregarded. This also means that an employee's subjective perception of the value of a fringe benefit is not relevant to the determination of a fringe benefit's fair market value. In addition, the cost incurred by you is not determinative of the fair market value of the fringe benefit. Special rules relate to the valuation of certain fringe benefits, as discussed later.

If a **fringe benefit cost is excluded** by law from income, the recipient will not be required to include in gross income the difference between the FMV and excludible cost of that fringe benefit.

For example, you can exclude from an employee's gross income amounts paid or incurred by you to provide dependent care assistance to employees. Even if the FMV of the dependent care assistance exceeds your cost, the excess is not includible in the employee's gross income. If the cost excluded by law is a limited amount, however, then the FMV of the fringe benefit attributable to any excess cost is includible.

If the vehicle special valuation rules, discussed later, are not used by a taxpayer entitled to use such rules, the value of the availability of an employer-provided vehicle is determined under general valuation principles. In general, this means the valuation must be determined by reference to the cost to a person of leasing from a third party the same or comparable vehicle on the same or comparable terms in the geographic area in which the vehicle is available for use. Unless the employee can substantiate that the same or comparable vehicle could have been leased on a cents-per-mile basis, the value of the availability of the vehicle cannot be determined by reference to a cents-per-mile rate applied to the number of miles the vehicle is driven. An example of a comparable lease term is the amount of time that the vehicle is available to the employee for use, that is, a one-year period.

If the non-commercial flight special valuation rule, discussed later, is not used (or is not properly used) by a taxpayer entitled to use the rule, the value of a flight on an employer-provided aircraft is determined under general valuation principles. For example, if an employee whose flight is primarily personal controls the use of an aircraft with respect to such flight, the flight is valued by reference to how much it would cost a person to charter the same or comparable aircraft for the same or comparable flight. The cost to charter the aircraft must be allocated among all employees on board the aircraft based on all the facts and circumstances, including which employee or employees controlled the use of the aircraft. Except as provided above, no additional amount should be included in the income of any employee whose flight is properly valued under the non-commercial flight special valuation rule, discussed later.

Note: If you include the value of a ***noncash*** fringe benefit in an employee's gross income, you cannot deduct this amount as compensation for services, but can only deduct the costs you incurred in providing the benefit to the employee. You may be allowed a cost recovery deduction under section 168 or a deduction under section 179 for an expense not chargeable to the capital account, or, if the noncash fringe benefit is property leased by you, a deduction for the ordinary and necessary business expense of leasing the property.

Example 1. On January 1, 1985, Ash Company owns and provides the use of an automobile with a fair market value of $20,000 to Mr. Rose, an employee, for the entire calendar year. Both Ash and Mr. Rose compute taxable income on the basis of the calendar year. Seventy percent of the use of the automobile by Mr. Rose is in connection with Ash's trade or business. If Ash uses the automobile lease valuation rule, discussed later, for valuing the availability of the automobile and takes into account the amount excludable as a working condition fringe, Ash would include $1,680 ($5,600, the Annual Lease Value, less 70 percent of $5,600) in Mr. Rose's gross income for 1985. Ash may not deduct the amount included in Mr. Rose's income as compensation for services. Ash may, however, determine a cost recovery deduction under section 168, subject to the limitations under section 280F, for tax year 1985.

Example 2. The facts are the same as in the above example except that Ash includes $5,600 in Mr. Rose's gross income, the value of the noncash fringe benefit without taking into accout the amount excludable as a working condition fringe. Ash may not deduct that amount as compensation for services, but may determine a cost recovery deduction under section 168, subject to the limitations under section 280F. For purposes of determining adjusted gross income, Mr. Rose may deduct $3,920 ($5,600 multiplied by the percent of business use) if he files Form 1040 and Form 2106.

Valuation of fringe benefits—special rules. There are special valuation rules that you may use, under certain circumstances, to value certain commonly provided fringe benefits. These special rules are the:

1) Automobile lease valuation rule,
2) Vehicle cents-per-mile valuation rule,
3) Commuting valuation rule,
4) Non-commercial flight valuation rule,
5) Commercial flight valuation rule, and
6) Employer-operated eating facility meal valuation rule.

The special valuation rules may be used by you for income tax, employment tax, and reporting purposes. Use of any of the special valuation rules is optional. For vehicles or automobiles you provide to employees, you need not use the same special valuation rule for all employees. You may use the automobile lease valuation rule for some employees, and the commuting and cents-per-mile rules for other employees. This discretionary use of special valuation rules, however, does not apply to the commercial and non-commercial flight valuation rules. Effective January 1, 1986, if you use one of the special rules to value the benefit provided to your employee, the employee may not use another special rule to value that benefit. The employee may, however, use general valuation principles (discussed earlier) based on facts and circumstances.

Effective January 1, 1986, your employee may only use a special valuation rule if you use it. If a special rule is used, it must be used for all purposes. If you properly use a special rule and your employee uses the special rule, the employee must include in gross income the amount determined by you under the rule less any amount reimbursed by the employee to you. If you properly use a special rule and properly determine the amount of an employee's working condition fringe under the general rule (discussed later) or under a special rule (see section 1.132–5T), and your employee uses the same special rule, the employee must include in gross income the amount determined by you less any amount reimbursed by the employee to you. You and your employees may use the special valuation rules to determine the amount of the reimbursement due you by the employees.

For purposes of valuing the use of availability of a vehicle, the consistency rules relating to the automobile lease valuation rule and the vehicle cents-per-mile valuation rule (discussed later), apply for 1987 and thereafter. Therefore, for 1985 and 1986 an employer may use any applicable special valuation rule (or no special valuation rule) to value the use or availability of a vehicle, subject to the rules below.

If you use the automobile lease valuation rule (discussed later) in 1985 or 1986 with respect to an automobile, the rule must be used for the entire calendar year with respect to the automobile except for any period during which the commuting valuation rule (discussed later) is properly used. If you use the vehicle cents-per-

mile valuation rule (discussed later) in 1985 or 1986 with respect to a vehicle, such rule must be used for the entire calendar year with respect to the vehicle except for any period during which the commuting valuation rule is properly used.

Example 1. Assume that an employer properly uses the automobile lease valuation rule in 1985. The employer may use the vehicle cents-per-mile valuation rule in 1986 if the requirements of the vehicle cents-per-mile valuation rule are satisfied.

Example 2. Assume that an employer does not use a special valuation rule to value the availability of an automobile in 1985. The employer may use any of the special valuation rules in 1986 if the requirements of the rule chosen are satisfied. The same applies for 1987.

Example 3. Assume that an employer properly uses the vehicle cents-per-mile valuation rule in 1985. The employer may continue to use the rule or use any of the other special valuation rules to value the benefit provided in 1986 if the requirements of the rule chosen are satisfied. Alternatively, the employer may use none of the special valuation rules in 1986 but use any of the rules in 1987 if the requirements of the rule chosen are satisfied.

You are considered to have **elected** to use a particular special valuation rule when you determine the value of the fringe benefit provided by applying the special valuation rule and you treat that value as the FMV of the fringe benefit for income, employment tax, and reporting purposes. You are not required to notify the Internal Revenue Service of the election.

Effective January 1, 1987, if you elect to use a special valuation rule you must notify the employee of the election by the later of January 31 of the calendar year for which the election is to apply or 30 days after you first provide the benefit to the employee. If you elect to use a special valuation rule with respect to 1986, you must notify the employee of the election by the later of March 31, 1986, or 30 days after you first provide the benefit to the employee. If you elect to use a special valuation rule with respect to 1985, you do not have to provide notification of this election to the employee.

The valuation formulas contained in the special valuation rules are provided only for use in connection with those rules. Therefore, when you properly apply a special valuation rule to a fringe benefit, the Internal Revenue Service will accept the value calculated under the rule as the FMV of that fringe benefit. However, when you do not properly apply a special valuation rule to a fringe benefit, or when you do not use a special valuation rule to value a fringe benefit, you may not determine the FMV of that fringe benefit by reference to any value calculated under any special valuation rule. In that case, you must determine the FMV under the general rules discussed earlier under *Valuation of fringe benefits.*

If you are using the special accounting rule, discussed below, (relating to the reporting of noncash fringe benefits), benefits which are deemed provided in a subsequent calendar year under that rule are considered as provided in the subsequent calendar year for purposes of the special valuation rules. Therefore, if a particular special valuation rule is in effect for a calendar year, it applies to benefits deemed provided during the calendar year under the special accounting rule.

Under the general income tax and reporting rule, you must determine the actual value of the fringe benefits provided in a calendar year by January 31 of the following calendar year. If the benefit is the personal use of a highway motor vehicle, you may determine the actual value for the calendar year, or determine the actual value as if the entire usage of the vehicle for the year by the employee is personal (100% income inclusion). Employees may use Form 2106 to figure business use of the vehicle if you include 100% in their income.

Instead of using the general rule under which you would report employee benefits on a calendar year basis, you may use the special accounting rule explained in the following paragraphs. The special accounting rule may not be used, however, for a fringe benefit that is a transfer of personal property (tangible or intangible) of a kind normally held for investment, or a transfer of real property.

Under the ***special accounting rule,*** you may treat the value of the benefits provided during the last two months of the calendar year or any shorter period, as paid in the next year. Thus, the value of benefits provided January 1, 1985, through October 31, 1985, would be treated as benefits provided in 1985. For years after 1985, the value of the benefits of the last two months of a calendar year is treated as provided in the next year together with the value of the benefits provided in the first 10 months of the next year.

Note: This does not mean that all benefits treated as provided during the last two months of a calendar year can be deferred until the next year. Only the value of the benefit actually provided during the last two months of the calendar year can be treated as provided in the next calendar year.

Use of the special accounting rule is optional. You may use the rule for some fringe benefits but not others. The period of use need not be the same for each fringe benefit. However, if you use the rule for a particular benefit, you must use the rule for all employees who receive that fringe benefit.

If you use the special accounting rule, your employee must use it for the same period as you do. Your employee may not use the special accounting rule, however, unless you use it.

Automobile lease valuation rule. If you provide an employee with an automobile that is available to the employee for an entire calendar year, the ***Annual Lease Value*** of that automobile is the value of the benefit provided (see discussion below). Except as otherwise provided, for an automobile that is available to an employee for less than an entire calendar year, the value of the benefit provided is either a prorated annual lease value or the ***Daily Lease Value*** (discussed below) which ever is applicable. Absent any exclusion (such as a working condition fringe, discussed later in the chapter), the amount of the annual lease value (or a prorated annual lease value or the daily lease value, as applicable) is included in the gross income of the employee. For purposes of this rule, the term **automobile** means any motorized four-wheeled vehicle manufactured primarily for use on public streets, roads, and highways.

The **annual lease value** of a particular automobile is figured as follows:

1) Determine the FMV of the automobile (as discussed later) as of the first date on which the automobile is made available to any employee for personal use. For an automobile first made available to any employee for personal use prior to January 1985, determine the fair market value as of January 1, 1985.
2) Select the dollar range in column 1 of the Annual Lease Value Table (shown below) corresponding to the fair market value of the automobile. Except as provided below, the annual lease value for each year of availability of the automobile is the corresponding amount in column 2 of the table.

Annual Lease Value Table

Automobile fair market value (1)	Annual Lease Value (2)
$0 to 999	$
1,000 to 1,999	
2,000 to 2,999	1,1
3,000 to 3,999	1,3
4,000 to 4,999	1,6
5,000 to 5,999	1,8
6,000 to 6,999	2,1
7,000 to 7,999	2,3
8,000 to 8,999	2,6
9,000 to 9,999	2,8
10,000 to 10,999	3,1
11,000 to 11,999	3,3
12,000 to 12,999	3,6
13,000 to 13,999	3,8
14,000 to 14,999	4,1
15,000 to 15,999	4,3
16,000 to 16,999	4,6
17,000 to 17,999	4,8
18,000 to 18,999	5,1
19,000 to 19,999	5,3
20,000 to 20,999	5,6
21,000 to 21,999	5,8
22,000 to 22,999	6,1
23,000 to 23,999	6,3
24,000 to 24,999	6,6
25,000 to 25,999	6,8
26,000 to 27,999	7,2
28,000 to 29,999	7,7
30,000 to 31,999	8,2
32,000 to 33,999	8,7
34,000 to 35,999	9,2
36,000 to 37,999	9,7
38,000 to 39,999	10,2
40,000 to 41,999	10,7
42,000 to 43,999	11,2
44,000 to 45,999	11,7
46,000 to 47,999	12,2
48,000 to 49,999	12,7
50,000 to 51,999	13,2
52,000 to 53,999	13,7
54,000 to 55,999	14,2
56,000 to 57,999	14,7
58,000 to 59,999	15,2

For vehicles having a FMV in excess of $59,999, the annual lease value is equal to: (.2 X the FMV of the automobile) + $500.

The annual lease values determined under these rules are based on a **4-year lease term.** Therefore, except as provided below, the annual lease value figured under the above rules will remain in effect for the period that begins with the first date the automobile lease valuation rule is applied by you to the automobile and ends on December 31 of the 4th full calendar year following that date. The annual lease value for each subsequent 4–year period is figured by determining the FMV of the automobile as of the January 1 following the period described in the previous sentence and selecting the amount in column 2 of the above table corresponding to the appropriate dollar range in column 1 of the table.

If, however, you are using the special accounting rule (relating to the reporting of noncash fringe benefits) discussed earlier, you must calculate the annual lease value for each subsequent 4-year period as of the beginning of the special accounting period that begins immediately prior to the January 1 described in the previous sentence. For example, assume that pursuant to Announcement 85–113, you use the special accounting rule. Assume further that beginning on November 1, 1985, the special accounting period is November 1 to October 31 and that you elect to use the automobile lease valuation rule as of January 1, 1985. You may recalculate the annual lease value as of November 1, 1988, rather than as of January 1 1989.

Unless the primary purpose of the transfer is to reduce federal taxes, if you **transfer** an auto

mobile from one employee to another employee, you may refigure the annual lease value based on the FMV of the automobile as of January 1 of the year of transfer. If you do not refigure the annual lease value, and the employee to whom the automobile is transfered uses the special valuation rule, the employee may not refigure the annual lease value. If, however, you are using the special accounting rule (relating to the reporting of noncash fringe benefits), you may recalculate the annual lease value based on the FMV of the automobile as of the beginning of the special accounting period in which the transfer occurs. If you do not recalculate the annual lease value, and the employee to whom the automobile is transferred uses the special valuation rule, the employee may not recalculate the annual lease value.

The annual lease values contained in the above table include the FMV of maintenance of, and insurance for, the automobile. You may not reduce the annual lease value by the FMV of any service included in the annual lease value that is not provided by you, such as reducing the annual lease value by the FMV of a maintenance service contract or insurance. You may take into account the services actually provided with respect to the automobile by valuing the availability of the automobile under the general valuation rules (see *Valuation of fringe benefits*, earlier).

The annual lease values do not include the FMV of fuel provided by you, regardless of whether you provide fuel in kind or reimburse its cost. The provision of fuel in kind may be valued at FMV based on all the facts and circumstances or, in the alternative, it may be valued at 5.5 cents per mile for all miles driven by the employee. However, the provision of fuel in kind may not be valued at 5.5 cents per mile for miles driven outside the United States (including its territories), Canada, and Mexico.

The FMV of fuel, the cost of which is reimbursed by or charged to you, is generally the amount of the actual reimbursement or the amount charged, provided the purchase of the fuel is at arm's length. If you are an employer with a fleet of at least 20 automobiles that meet the requirements of the fleet-average valuation rule (mentioned later) and you reimburse your employees for the cost of fuel or allow them to charge you for the cost of fuel, the FMV of the fuel may be determined by reference to your *fleet-average cents-per-mile fuel cost*. See section 1.61–2T(d)(3)(ii)(C) of the Income Tax Regulations.

The FMV of any service (other than the maintenance of, and insurance for, an automobile) that is provided by you with respect to an automobile (such as the services of a chauffeur) must be **added** to the annual lease value of the automobile in determining the FMV of the benefit provided.

For periods of continous availability of 30 or more days, but less than an entire calendar year, the value of the availability of the employer-provided automobile is the **pro-rated annual lease value.** A pro-rated annual lease value may not be used however, when the primary reason the automobile is unavailable to an employee during the calendar year is the reduction of federal taxes. The pro-rated annual lease value is figured by multiplying the applicable annual lease value by a fraction, the numerator of which is the number of days of availability and the denominator of which is 365.

For periods of continuous availability of one or more but less than 30 days, the value of the availability of the employer-provided automobile is the **daily lease value.** The daily lease value is figured by multiplying the applicable annual lease value by a fraction, the numerator of which is four times the number of days of availability and the denominator of which is 365. However, a pro-rated annual lease value may be applied with respect to a period of continuous availability of less than 30 days by treating the automobile as if it had been available for 30 days, if to do so would result in a lower valuation than applying the daily lease value to the shorter period of actual availability.

If an automobile is unavailable because of personal reasons of the employee (for example, if the employee is on a vacation), a pro-rated annual lease value may not be used.

For purposes of determining the annual lease value of an automobile under the above table, the **FMV** of an automobile is that amount a person would have to pay a third party to purchase the particular automobile provided. Except as provided below, the cost incurred by you of either purchasing or leasing the automobile is not determinative of the FMV of the automobile.

For purposes of figuring the annual lease value of an automobile under the automobile lease valuation rule, the **safe-harbor value** of the automobile may be used as the FMV of the automobile. For an automobile owned by you, the safe-harbor value of the automobile is your cost of purchasing the automobile provided that the purchase is made at arm's length. For an automobile leased by you, the safe-harbor value of the automobile is the value retail of the automobile obtained from a nationally recognized publication that regularly reports new or used automobile retail values. The values obtained from the publication must be reasonable for that automobile.

The FMV of an automobile does not include the FMV of any telephone or any **specialized equipment** that is added to or carried in the automobile if the presence of the equipment is necessitated by and attributable to your business needs. However, the value of specialized equipment must be included if the employee to whom the automobile is available uses the specialized equipment in a trade or business of the employee other than the employee's trade or business of being your employee. The exclusion rule discussed above does not apply to equipment susceptible to personal use.

If you are an employer with a fleet of 20 or more automobiles, you may use a fleet-average value for purposes of calculating the annual lease values of the automobiles in the fleet. See section 1.61–2T(d)(5)(v) of the Income Tax Regulations.

Except as provided under the fleet-average valuation rule, you may adopt the automobile lease valuation rule for an automobile only if the rule is adopted with respect to the later of the period that begins on January 1, 1987, or the first period in which the automobile is made available to one of your employees for personal use or, if the commuting valuation rule (discussed later) is used when the automobile is first made available to your employee for personal use, the first period in which the commuting valuation rule is not used.

Once you have adopted the automobile lease valuation rule for an automobile, you must use the rule for all subsequent periods in which you make the automobile available to any employee, that you may, for any period during which use of the automobile qualifies for the commuting valuation rule, use the commuting valuation rule with respect to the automobile.

If you use the automobile lease valuation rule, or you and an employee use the rule, with respect to a particular automobile, and a replacement automobile is provided to the employee for the primary purpose of reducing federal taxes, then you, or you and the employee, using the rule must continue to use the rule with respect to the replacement automobile.

Vehicle cents-per-mile valuation rule. If you provide an employee with the use of a vehicle that you reasonably expect will be regularly used in your trade or business throughout the calendar year (or such shorter period as the vehicle may be owned or leased by you) or satisfies the requirements of the *mileage rule* discussed below, the value of the benefit provided is the standard mileage rate multiplied by the total number of miles the vehicle is driven by the employee for personal purposes. For 1985 this rate is 21 cents per mile for the first 15,000 miles and 11 cents per mile for all miles over 15,000. See Rev. Proc. 85-49. The standard mileage rate must be applied to personal miles independent of business miles. For purposes of this rule, the use of a vehicle for personal purposes is any use of the vehicle other than use in the employee's trade or business of being your employee. Infrequent use of the vehicle, such as for trips to the airport or between your multiple business premises, does not constitute regular use of the vehicle in your trade or business.

A vehicle satisfies the requirements of the **mileage rule** in a calendar year if (1) it is actually driven at least 10,000 miles in that year, and (2) use of the vehicle during the year is primarily by employees. For example, if a vehicle is used by only one employee during the year and that employee drives a vehicle at least 10,000 miles in a calendar year, such vehicle satisfies the mileage rule even if all miles driven by the employee are personal. The mileage rule will not be satisfied if during the year the vehicle is transferred among employees in such a way which enables an employee whose use was at a rate significantly less than 10,000 miles per year to meet the 10,000 mile threshold.

Assume that an employee uses a vehicle for the first six months of the year and drives 2,000 miles, and that vehicle is then used by other employees who drive the vehicle 8,000 miles in the last six months of the year. Because the rate at which miles were driven in the first six months of the year would result in only 4,000 miles being driven in the year, and because the first employee did not use the vehicle during the last six months of the year, the requirements of the mileage rule are not satisfied. The requirement of item (2) above is deemed satisfied if employees use the vehicle on a consistent basis for commuting. If the employer does not own or lease the vehicle during a portion of the year, the 10,000 mile threshold is to be reduced proportionately to reflect the periods when the employer owned or leased the vehicle. For this purpose, use of the vehicle by an individual (other than the employee) whose use would be taxed to the employee is not considered use by the employee.

The value of the use of an automobile (as defined earlier under *Automobile lease valuation rule*) may not be determined under this vehicle cents-per-mile valuation rule if the FMV of the automobile (determined earlier under *Annual lease valuation rules*) as of the later of January 1, 1985, or the first date on which the automobile is made available to your employees for personal use or, exceeds the value of a vehicle for which the maximum recovery deduction under section 280F (a)(2) may be claimed. For 1985, that value is $12,800.

For purposes of this vehicle cents-per-mile valuation rule, the term **vehicle** means any motorized wheeled vehicle manufactured primarily for use on public streets, roads, and highways. This term includes an automobile as defined earlier under *Automobile lease valuation rule.*

The cents-per-mile rate includes the FMV of maintenance of, and insurance for, the vehicle. You may not reduce the rate by the FMV of any service included in it but not provided by you. You may take into account the services provided with respect to the automobile by valuing the availability of the automobile under the general valuation rules (discussed earlier).

With respect to miles driven in the United States (and its territories), Canada, and Mexico, the cent-per-mile rate includes the FMV of fuel provided by you. If you do not provide fuel, the rate may be reduced by no more than 5.5 cents or the amount specified in any applicable revenue ruling or revenue procedure.

With respect to miles driven outside the United States, Canada, and Mexico, the fair market value of fuel provided by the employer is not reflected in the cents-per-mile rate. Accordingly, the cents-per-mile rate may be reduced but by no more than 5.5 cents or the amount specified in any applicable revenue ruling or revenue procedure. If you provide the fuel in kind, it must be valued based on all the facts and circumstances. If you reimburse the employee for the cost of fuel or allow the employee to charge you for the cost of fuel, the fair market value of the fuel is generally the amount of the actual reimbursement or the amount charged, provided the purchase of fuel is at arm's length.

If you use this vehicle cents-per-mile valuation rule, you may only value the miles driven for personal use. Thus, you must include an amount in an employee's income with respect to the use of a vehicle that is equal to the product of the number of personal miles driven by the employee and the appropriate cents-per-mile rate. You may not include in income a greater or lesser amount; for example, you may not include in income 100 percent (all business and personal miles) of the value of the use of the vehicle. The term **personal miles** means all miles driven by the employee except for miles driven by the employee in the employee's trade or business of being your employee.

You must adopt this vehicle cents-per-mile valuation rule for a vehicle by the later of the period that begins on January 1, 1987, or the first period in which the vehicle is used by an employee for personal use or, if the commuting valuation rule (discussed later) is used when the vehicle is first used by an employee for personal use, the first period in which the commuting valuation rule is not used.

Once you have adopted the vehicle cents-per-mile valuation rule for a vehicle, you must use the rule for all subsequent periods in which the vehicle qualifies for use of the rule, except that (1) you may, for any period during which use of the vehicle qualifies for the commuting valuation rule, use the commuting valuation rule with respect to the vehicle, and (2) if you elect to use the automobile lease valuation rule for a period in which the vehicle does not qualify for use of the vehicle cents-per-mile rule, you must comply with the consistency rules, discussed earlier under *Automobile lease valuation rule*. If the vehicle fails to qualify for use of the vehicle cents-per-mile valuation rule during a subsequent period, you may adopt for such subsequent period and thereafter any other special valuation rule for which the vehicle then qualifies. For purposes of the consistency rules (discussed earlier), the first day on which an automobile with respect to which the vehicle cents-per-mile rule had been used fails to qualify for use of the vehicle cents-per-mile valuation rule may be deemed to be the first day on which the automobile is available to your employee for personal use.

If you use this vehicle cents-per-mile valuation rule, or you and an employee use the rule, with respect to a particular vehicle, and a replacement vehicle is provided to the employee for the primary purpose of reducing federal taxes, then you, or you and the employee, using the rule must continue to use the rule with respect to the replacement vehicle if the replacement vehicle qualifies for use of the rule.

Commuting valuation rule. Under this special rule, the value of the commuting use of an employer-provided vehicle is $1.50 per one-way commute (that is, from home to work or from work to home) for each employee who commutes in the vehicle. The term **vehicle** means any motorized wheeled vehicle manufactured primarily for use on public streets, roads, and highways. The term vehicle includes an automobile as defined earlier under *Automobile lease valuation rule*.

You may use this special rule to compute commuting value if you and your employees meet all of the following criteria with respect to the vehicle:

1) You own or lease the vehicle and provide it to one or more employees for use in connection with your trade or business and the vehicle is used in your trade or business,
2) For bona fide noncompensatory business reasons, you require the employee to commute to and/or from work in the vehicle,
3) You have established a policy (must be in writing for commuting use after 1985) under which the employee may not use the vehicle for personal purposes, other than for commuting or de minimis personal use (such as a stop for a personal errand on the way between a business delivery and the employee's home),
4) Except for de minimis personal use, the employee does not use the vehicle for any personal purpose other than commuting, and
5) The employee required to use the vehicle for commuting is not a control employee (as defined below) of yours.

If the vehicle is a chauffeur-driven vehicle, this commuting valuation rule may not be used to value the commuting use of any passenger who commutes in the vehicle. The rule may be used, however, to value the commuting use of the chauffeur. Personal use of a vehicle is all use of the vehicle by an employee that is not use in the employer's trade or business of being your employee.

The policy described in (3) above prohibiting personal use need not be written with respect to the commuting use which occurs prior to January 1986.

For commuting use that occurs during 1985, the restrictions of item (5) above apply only to an employee who is an officer or a 5% owner of the employer, rather than to a control employee. For purposes of determining who is a 5% owner, any individual who owns (or is considered as owning) 5% or more of the FMV of an entity (the "owned entity") is considered a 5% owner of all entities that would be aggregated with the owned entity under the rules of section 414(b), (c), or (m) of the Internal Revenue Code. Your employee who is an officer will be treated as an officer of all entities treated as a single employer under the rules of section 414(b), (c), or (m). The definitions provided in items (1) of a *non-government employer* and items (1), (2), and (3) of a *government employer* may be used to define an officer in 1985.

If the vehicle in which the employee is required to commute is not an automobile as defined earlier under *Automobile lease valuation rule*, the restrictions under item (5) above do not apply.

A control employee of a **non-government employer** is any employee:

1) Who is a board- or shareholder-appointed, confirmed, or elected officer of the employer,
2) Who is a director of the employer, or
3) Who owns a 1% or greater equity, capital, or profits interest in the employer.

For purposes of determining who is a 1% owner under item (3) above, any individual who owns (or is considered as owning under the attribution rules of section 318(a) of the Internal Revenue Code or principles similar to section 318(a) for entities other than corporations) 1% or more of the FMV of an entity (the "owned entity") is considered a 1% owner of all entities that would be aggregated with the owned entity under the rules of section 414(b), (c), (m), or (o) of the Internal Revenue Code. An employee who is an officer of an employer shall be treated as an officer of all entities treated as a single employer under section 414(b), (c), (m), or (o).

A control employee of a **government employer** is any:

1) Elected official,
2) Federal employee who is appointed by the President and confirmed by the Senate. In the case of commissioned officers of the U.S. Armed Forces, an officer is any individual with the rank of brigadier general or above or the rank of rear admiral (lower half) or above, or
3) State, or local executive officer comparable to the individuals described in items (1) and (2) above.

For purposes of this commuting valuation rule, the term government includes any federal, state, or local governmental unit and any agency or instrumentality thereof.

Non-commercial flight valuation rule. If an employee is provided with a flight on an employer-provided aircraft, the value of the flight is calculated using the aircraft valuation formula, described later. Except as otherwise provided, for purposes of this rule, a flight provided to a person whose flight would be taxable to an employee as the recipient is referred to as provided to the employee, and a flight taken by that person is considered a flight taken by the employee.

This valuation rule may be used to value flights on all employer-provided aircraft, including helicopters. This valuation rule may be used to value international as well as domestic flights. This valuation rule may not be used to value a flight on any commercial aircraft on which air transportation is sold to the public on a per-seat basis. For a special valuation rule relating to certain flights on commercial aircraft, see the discussion later.

Except as provided under section 1.61-2T(g)(3)(iii) of the Income Tax Regulations relating to intermediate stops, for purposes of this non-commercial flight valuation rule, an individual's flight is the distance (in statute miles) between the place at which the individual boards the aircraft and the place at which the individual deplanes.

Under this valuation rule, value is determined separately for each flight. Therefore, a round-trip is comprised of at least two flights. For example, an employee who takes a personal trip on an employer-provided aircraft from New York, New York to Denver, Colorado, Denver to Los Angeles, California, and Los Angeles to New York has taken three flights and must apply the aircraft valuation formula separately to each flight. The value of a flight must be determined on a passenger-by-passenger basis. For example, if an individual accompanies the employee and the flight taken by the individual would be taxed to the employee, the employee would be taxed on the special rule value of the flight by the employee and by the individual.

If the primary purpose of a landing is necessitated by weather conditions, by an emergency, for purposes of refueling or obtaining other services relating to the aircraft, or for purposes of your business unrelated to the employee whose flight is being valued (an intermediate stop), the distance between the place at which the trip originates and the place at which the intermediate stop occurs is not considered a flight. For example, assume that an employee's trip originates in St. Louis, Missouri, on route to Seattle, Washington, but, because of weather conditions, the aircraft lands in Denver, Colorado, and the employee stays in Denver overnight. Assume further that the next day the aircraft flies to Seattle where the employee deplanes. The employee's flight is the distance between the airport in St. Louis and the airport in Seattle. Assume that a trip originates in New York, New York, with five passengers and makes an intermediate stop in Chicago, Illinois, before going on to Los Angeles, California. If one of the five passengers deplanes in Chicago, the distance of that passenger's flight would be the distance between the airport in New York and the airport in Chicago. The intermediate stop is disregarded when measuring the flights taken by each of the other passengers. Their flights would be the distance between the airport in New York and the airport in Los Angeles.

The non-commercial flight valuation rule applies to personal flights on employer-provided aircraft. A personal flight is one the value of which is not excludable under another section of subtitle A, such as section 132(d) (relating to a working condition fringe).

The value of a flight is determined by multiplying the base aircraft valuation formula by the appropriate aircraft multiple (discussed later) and then adding the applicable terminal charge. The base aircraft valuation formula (also known as the **Standard Industry Fare Level Formula** or SIFL) in effect on June 30, 1985, was as follows: $.1402 per mile for the first 500 miles, $.1069 per mile for miles between 501 and 1500, and .1028 per mile for miles over 1500. The terminal charge in effect on June 30, 1985, was $25.62. The SIFL cents per-mile rates in the formula are calculated by the Department of Transportation and are revised semi-annually.

In determining the value of a particular flight during the first 6 months of a calendar year, the SIFL formula (and terminal charge) in effect on Dec. 31 of the preceding year applies, and in determining the value of a particular flight during the last 6 months of a calendar year, the SIFL formula (and terminal charge) in effect on June 30 of that year applies. The following is the SIFL formula that was in effect on December 31, 1984: $.1480 per mile for the first 500 miles, $.1128 per mile for miles between 501 and 1500, and $.1085 per mile for miles over 1500. The terminal charge in effect on December 31, 1984, is $27.05.

The **aircraft multiples** are based on the maximum certified takeoff weight of the aircraft. For purposes of applying the aircraft valuation formula described above, the aircraft multiples are as follows:

Maximum Certified Takeoff Weight of the Aircraft	Aircraft multiple for a Control Employee	Aircraft multiple for a Non-Control Employee
6,000 lbs. or less	62.5 percent	15.6 percent
6,001 – 10,000 lbs.	125 percent	23.4 percent
10,001 – 25,000 lbs.	300 percent	31.3 percent
25,001 lbs or more	400 percent	31.3 percent

Except as provided under the special seating capacity rule (discussed below), any flight provided to an individual whose flight would be taxable to a control employee (as defined in section 1.61-2T(g)(8) and (9) of the Income Tax Regulations) as the recipient shall be valued as if the flight had been provided to that control employee. For example, assume that your chief executive officer, his spouse, and his two children fly on an employer-provided aircraft for personal purposes. Assume further that the maximum certified takeoff weight of the aircraft is 12,000 lbs. The amount includible in the employee's income is 4 × ((300% × base aircraft valuation formula) plus the applicable terminal charge).

Seating capacity rule. Where 50% or more of the regular passenger seating capacity, discussed later, of an aircraft (as used by you) is occupied by individuals whose flights are primarily for your business (and whose flights are excludable from income as a working condition fringe, discussed later in this chapter), the value of a flight on that aircraft by any employee who is not flying primarily for your business (or who is flying primarily for your business but the value of whose flight is not excludable from income as a working condition fringe by reason of certain foreign travel) is deemed to be zero. For purposes of this seating capacity rule, the term **employee** includes only employees and partners of the employer providing the aircraft and does not include independent contractors and directors of the employer.

This 50% seating rule does not apply to individuals who are treated as employees under the fringe benefit rules discussed later. If a flight is taken by an individual who would otherwise be treated as an employee under the fringe benefit rules and the value of that individual's flight is not excludable as a working condition fringe benefit (discussed later), then the value of the flight provided to such individual is the value of a flight provided to a non-control employee (even if the individual who would be taxed on the value of such individual's flight is a control employee).

The seating capacity rule must be met both at the time the individual whose flight is being valued boards the aircraft and at the time the individual deplanes. For example, assume that employee A boards an employer-provided aircraft for personal purposes in New York, New York and that at that time 80% of the regular passenger seating capacity of the aircraft is occupied by individuals whose flights are primarily for your business (and whose flights are excludable from income as a working condition fringe, discussed later) ("the business passengers"). If the aircraft flies directly to Hartford, Connecticut where all of the passengers, including A, deplane, the requirements of the seating capacity rule have been satisfied.

If instead, some of the passengers, including A, remain on the aircraft in Hartford and the aircraft continues on to Boston, Massachusetts, where they all deplane, the requirements of the seating capacity rule will not be satisfied unless at least 50% of the seats comprising the aircraft's regular passenger seating capacity were occupied by the business passengers at the time A deplanes in Boston.

The **regular passenger seating capacity** of an aircraft is the maximum number of seats that have at any time been on the aircraft (while owned or leased by you). Do not count those seats that cannot be legally used during takeoff and that are not used at any time during takeoff. Seats occupied by a memeber of the flight crew are not counted unless the purpose of the flight of such individual is not primarily to serve as a member of the flight crew.

If the non-commercial flight valuation rule is used by you to value flights provided in a calendar year, the rule must be used to value all flights provided in the calendar year.

If you use the non-commercial flight valuation rule to value a flight taken by a control employee, on a return as originally filed, on the grounds that either the control employee is not in fact a control employee, or that the aircraft is within a specific weight classification, and either position is later determined to be in error, you cannot use this valuation rule (including the transitional valuation rule discussed below) to value the flight taken by that control employee. Also, you cannot use these valuation rules to value a flight taken by an employee, if, on a return as originally filed, you exclude from the employee's income the value of the flight on the grounds it was excludable as a working condition fringe and this position is later determined to be in error.

There is a **transitional valuation rule** available only for flights provided during 1985. If the value of a flight determined under this transitional rule is lower than the value of the flight otherwise determined under the non-commercial flight valuation rule, the value of the flight is the lower amount.

The appropriate aircraft multiples under the transitional valuation rule are as follows:

1) 125% of the base aircraft valuation formula plus the applicable terminal charge for any flight by an employee who is not a key employee.
2) 125% of the base aircraft valuation formula plus the applicable terminal charge for a flight by a key employee if there is a primary business purpose for the trip by the aircraft. For the purpose of this paragraph (2), entertaining an employee or other individual is not a business purpose.
3) 600% of the base aircraft valuation formula plus the applicable terminal charge for a flight by a key employee if there is no primary business purpose for the trip by the aircraft.

Where there is no business purpose for the trip by the aircraft, the transitional valuation rule may not be used to value a flight by a key employee. For purposes of the non-commercial flight valuation rule, compensating an employee is not a business purpose.

A **key employee** is any employee who is a 5% owner or an officer of the employer, or who, with respect to a particular trip by the aircraft, controls the use of the aircraft. For purposes of determining who is a 5% owner, any individual who owns (or is considered as owning) 5% or more of the FMV of an entity (the "owned entity") is considered a 5% owner of all entities that would be aggregated with the owned entity as if they were required to be treated as a single employer, as discussed earlier.

If you use the transitional valuation rule on a return as originally filed to value a flight taken by a key employee on the grounds that the flight had a primary business purpose, the flight had some business purpose, or the key employee is not in fact a key employee, and this position is later determined to be in error, you cannot use the transitional valuation rule nor the noncommercial flight valuation rule to value the flight taken by that key employee.

Commercial flight valuation rule. Under this commercial valuation rule, the value of a space-available flight (as defined below) on a commercial aircraft is 25% of the actual carrier's highest unrestricted coach fare in effect for the particular flight taken.

This commercial flight valuation rule is available to value a **space-available flight** which is defined as a flight on a commercial aircraft for

which the airline (the actual carrier) incurs no substantial additional cost (including foregone revenue) determined without regard to any amount paid for the flight and which is subject to the same types of restrictions customarily associated with flying on an employee "stand-by" or "space-available" basis. A flight may be a space-available flight even if the airline that is the actual carrier is not the employer of the employee.

If the actual carrier does not offer, in the ordinary course of its business, air transportation to customers on a per-seat basis, this commercial flight special valuation rule is not available. Therefore, if, in the ordinary course of your line of business, you only offer air transportation to customers on a charter basis, you may not use this commercial flight valuation rule to value a space-available flight on your aircraft. Similarly, if, in the ordinary course of your line of business, you only offer air transportation to customers for the transport of cargo, this commercial flight valuation rule may not be used to value a space-available flight on your aircraft.

The date that the flight is taken is the relevant date for purposes of applying these valuation rules. The date of purchase or issuance of a pass or ticket is not relevant. Therefore, this special valuation rule applies to a flight taken after December 31, 1984, regardless of the date on which the pass or ticket for the flight was purchased or issued.

If you use the commercial flight valuation rule to value flights provided in a calendar year, you must use the rule to value all flights provided in the calendar year.

Valuation of meals provided at an employer-operated eating facility for employees. The value of all meals provided at an employer-operated eating facility for employees during a calendar year is 150% of the direct operating costs of the eating facility ("total meal value").

The taxable value of meals provided at an eating facility may be determined in two ways. The individual meal subsidy (see below) may be treated as the taxable value of a meal provided at the eating facility. Otherwise, you may allocate the total meal subsidy among employees (see below).

The **individual meal subsidy** is determined by multiplying the price charged for a particular meal by a fraction, the numerator of which is the total meal value and the denominator of which is the gross receipts of the eating facility and then subtracting the amount paid for the meal. The taxable value of meals provided to a particular employee during a calendar year, therefore, is the sum of the individual meal subsidies provided to the employee during the calendar year.

Instead of using the individual meal value method, you may allocate the **total meal subsidy** (total meal value less the gross receipts of the facility) among employees in any manner reasonable under the circumstances.

The **direct operating costs** of an eating facility are the costs of food and beverages and the cost of labor for personnel whose services relating to the facility are performed primarily on the premises of the eating facility. Thus, for example, the labor costs for cooks, waiters, and waitresses is included in direct operating costs but the labor cost for a manager of an eating facility whose services relating to the facility are not primarily performed on the premises of the eating facility is not included in direct operating costs. The direct operating costs test must be applied separately for each dining room or cafeteria.

An **employer-operated eating facility for employees** is a facility that meets all of the following conditions:

1) You own or lease the facility,
2) You operate the facility,
3) The facility is located on or near your business premises,
4) Substantially all of the use of the facility you are operating is by your employees, and
5) The meals furnished at the facility are provided during, or immediately before or after, the employee's workday.

You are considered to operate the eating facility if you contract with another to operate it. The term **meals** means food, beverages, and related services provided at the facility. Each dining room or cafeteria in which meals are served is treated as a separate eating facility, regardless of whether each dining room or cafeteria has its own kitchen or other food-preparation area.

For rules relating to an exclusion for the value of meals provided at an employer-operated eating facility for employees, see the discussion later.

Substantiation requirements. For tax years beginning after 1985, you must substantiate your business/investment use of listed property by showing either:

1) That, based on evidence that satisfies the recordkeeping requirements of section 274(d) of the Internal Revenue Code or statements submitted by employees that summarize such evidence, all or a portion of the use of the listed property is by employees in your trade or business and, if any employee used the property for personal purposes, you include an appropriate amount in the employee's income, or
2) In the case of a vehicle, the employer treats all use by employees as personal use and includes an appropriate amount in the employees' income.

You may rely on adequate records maintained by the employee or on the employee's own statement if corroborated by other sufficient evidence unless the employer knows or has reason to know that the statement, records, or other evidence are not accurate. You must retain a copy of the adequate records maintained by the employee or the other sufficient evidence, if available. Alternatively, you may rely on a statement submitted by the employee that provides sufficient information to allow you to determine the business/investment use of the property unless you know or have reason to know that the statement is not based on adequate records or on the employee's own statement corroborated by other sufficient evidence. If you rely on the employee's statement, you must retain only a copy of the statement. The employee must retain a copy of the adequate records or other evidence.

Listed property includes, but is not limited to:

1) Passenger automobiles,
2) Any other property used as a means of transportation if the nature of the property lends itself to personal use (that is, motorcycles, pick-up trucks, etc.),
3) Any property of a type generally used for purposes of entertainment, recreation, or amusement (that is, photographic, phonographic, communication, and video recording equipment), and
4) Computers and peripheral equipment.

For more information on listed property see Publication 534, *Depreciation.*

Exclusion of fringe benefits. Certain fringe benefits you provide to an employee are excluded from the employee's gross income. See Publication 525, *Taxable and Nontaxable Income,* for additional information on excludable fringe benefits. Also, if at the time the benefits are provided to the employee it is reasonable to believe that the employee will be able to exclude the benefits from income, the benefits are not subject to federal income tax withholding, social security taxes (FICA), or federal unemployment tax (FUTA). These fringe benefits that are excludible from gross income include:

1) A no-additional-cost service,
2) A qualified employee discount,
3) A working condition fringe,
4) A de minimis fringe,
5) Athletic facilities, and
6) A qualified tuition reduction.

No-additional-cost service. To be excludible, a no-additional-cost service must be the same kind of service offered for sale to nonemployee customers in the ordinary course of your line of business in which the employee works. If you have more than one line of business, see *Election by multi-line business,* later. You cannot incur substantial additional cost, including lost revenue, in providing the service to an employee. Examples: excess airline, bus, or train tickets, unused hotel rooms, or telephone services provided free or at a reduced price to employees working in those lines of business.

Generally, an employer's line of business is determined by reference to the Enterprise Standard Industrial Classification Manual (ESIC Manaul) prepared by the Statistical Policy Division of the U.S. Office of Management and Budget.

Employees can exclude no-additional-cost service benefits provided by another unrelated employer in the same line of business under a written ***reciprocal agreement*** between you and the other employer, if:

a) The above rules are met, and
b) The service is provided at no substantial additional cost to either employer.

For example, two unrelated airlines provide free space-available flights to each other's employees. If the airlines meet the requirements in (a) and (b), the value of the flights can be excluded from the recipient employees income.

For purposes of the no-additional-cost service, ***employee*** includes a retired or disabled employee and a surviving spouse of an employee. The use of these fringe benefits by spouse or dependent child (including a child both of whose parents have died) of the employee is treated as use by the employee. A child of divorced parents is treated as a dependent of both.

Qualified employee discount. To be excludible, the employee discount for qualified property must not exceed your ***gross profit percentage*** and, for qualified services, must not exceed 20% of the price at which the service is offered to nonemployee customers. Qualified property or services include property (other than personal property of a kind held for investment and real property) or services offered for sale to nonemployee customers in the ordinary course of your line of business in which the employee works. For purposes of this discount exclusion, a leased section of a department store is treated as part of the line of business of the person operating the department store, and employees working in the leased section are treated as employees of the person operating the department store. For an exception to the line of business limitation, see *Election by multi-line business,* later.

The gross profit percentage is determined on the basis of all property offered to customers (including employee customers) in the ordinary course of your line of business in which the employee works, and your experience during a

epresentative period. If you have more than ne line of business, see *Election by multi-line usiness*, later. The gross profit percentage is he percent that the excess of the total sales rice of the property sold by you to customers ver the total cost of the property is of the total ales price of the property.

For purposes of the qualified employee dis- ount, employee (or use by an employee) in- ludes the same individuals as explained above nder *No-additional-cost service*.

Working condition fringe. Any property or ervices you provide to an employee is exclud- ble as a working condition fringe to the extent hat, if the employee paid for the property or ervices, the payment would be deductible by he employee as a business expense. If the pay- ent would be deductible in a business of the mployee, other than the employee's business f being your employee, the payment will not e deemed allowable as a deduction for pur- oses of determining the amount, if any, of the orking condition fringe. Examples: Company ar for business use and subscriptions to busi- ess magazines provided to employees. Under pecial rules, all of the use of a demonstrator ar by a full-time auto salesperson is excluded f the use is mainly to facilitate the services pro- ided for you by the salesperson and there are estrictions on personal use. Also, the value of arking facilities provided to employees on or ear your business premises are excluded. The ondiscrimination rule, discussed later, does ot apply to a working condition fringe.

De minimis fringe. This excludible benefit is ny property or service you provide to an em- loyee (taking into consideration how fre- uently similar fringe benefits are provided) that as so small a value as to make accounting for he benefit unreasonable or administratively im- racticable. Examples: typing of a personal let- er by a company secretary; occasional personal use of a company copying machine; monthly transit passes provided at a discount not in excess of $15; occasional parties or pic- nics for employees; occasional supper money and taxi fare for employees working overtime; holiday gifts with a low fair market value; occa- sional tickets for entertainment events; and coffee or doughnuts furnished to employees. The nondiscrimination rule, discussed later, does not apply to a de minimis fringe, except for an eating facility described next.

Also, your employees can exclude from gross income the value of meals at an employer-oper- ated eating facility, if the annual income from the facility normally equals or exceeds the di- rect operating costs of the facility. The nondis- crimination rule, discussed later, applies to this eating facility benefit. For more information, in- cluding definitions of an employer-operated eat- ing facility and direct operating costs, see *Valuation of meals provided at an employer-op- erated eating facility for employees*.

Athletic facilities. Your employees can ex- clude from gross income the value of an on- premises gym or other athletic facility provided and operated by you if substantially all the use during the calendar year is by employees, their spouses, and their dependent children (as ex- plained earlier under *No-additional-cost ser- vice*). This exclusion is not available for country clubs or health clubs which are open to the public or for facilities which are part of a resort or residential building. For purposes of this ex- clusion the nondiscrimination rule, discussed later, does not apply. Your expenses for the fa- cility, however, will not be allowed as a deduc- tion if it is operated primarily for the benefit of officers, owners, or highly compensated em- ployees.

A qualified tuition reduction for education furnished after June 30, 1985, is also excluded from an employee's gross income and is not subject to employment taxes. A qualified tuition reduction is a reduction that an educational or- ganization provides its employees for educa- tion at that organization or other educational organization. Generally, the tuition reduction must be for education below the graduate level. The education must be offered to employees on a non-discriminatory basis.

Nondiscrimination rule. For the exclusion to apply, the no-additional-cost service and quali- fied employee discount fringe benefits must be available on substantially the same terms to each member of a group of employees. The employee group must be defined under a rea- sonable classification set up by the employer that does not discriminate in favor of highly compensated group consisting of officers, own- ers, or highly compensated employees (the "prohibited group"). If this nondiscrimination test is not satisfied, these fringe benefits can be excluded only by the employees who receive them and who are not members of the prohib- ited group.

Election by multi-line-business. If you are an employer with more than one line of business which existed on January 1, 1984, and you filed an election by December 31, 1985 to treat the employees of all your lines of business as em- ployees of one of those lines of business, then the employees of all your lines of business may exclude certain fringe benefits received from that one line of business. The election applies to qualified employee discounts. It also applies to no-additional-cost services, except that it does not apply to services provided to employ- ees of an unrelated employer under a recipro- cal agreement, discussed earlier.

The election is effective for 1985 and all later calendar years, unless you file a revocation (ef- fective for the calendar year following the year in which filed). If you did not file an election for 1985, you cannot file one for any later year.

A 30 percent nondeductible excise tax on fringe benefits is imposed on employers for any calendar year the election is in effect. The amount of any excess fringe benefits is figured by subtracting 1 percent of the aggregate em- ployee compensation paid by the employer dur- ing the year from the aggregate value of excludible no-additional-cost services and em- ployee discounts provided by the employer dur- ing the year.

3. Employee Benefit Plans

An employee benefit plan can be set up ei- ther to provide retirement benefits or to defer compensation. If it is set up to provide retire- ment benefits, it can do so by deferring com- pensation or by allowing employees to make deductible contributions under the plan.

Compensation is deferred when contributions for services rendered are accumulated to pro- vide benefits at some future date. If a plan is set up to defer compensation, the employees do not necessarily need to wait until retirement to begin receiving benefits.

Among the various types of employee benefit plans are qualified employee benefit plans, non- exempt trusts and annuity plans, self-employed retirement plans, individual retirement arrange- ments, and simplified employee pensions.

Qualified Employee Benefit Plans

A qualified employee benefit plan is a written plan that you, as an employer, establish for the exclusive benefit of your employees and their beneficiaries. Contributions to these plans may be made by you, by your employees, or by both. You can deduct your contributions to the plan when you make them. Your employees generally are not taxed on your contributions to the plan or earnings on these contributions un- til they are distributed to them. However, cer- tain loans made from qualified employer plans after August 13, 1982, are treated as distribu- tions to employees or beneficiaries who receive the loans, and may result in taxable income to them.

To be a qualified plan, the plan must meet many requirements. Among these requirements are rules concerning who must be covered by the plan, how much of an employee's interest in the plan must be guaranteed, how contribu- tions to the plan are to be invested, and how contributions to the plan and benefits under the plan are to be determined. Most qualified plans must operate through an exempt trust.

There are two basic types of qualified em- ployee benefit plans: defined contribution plans and defined benefit plans.

Defined contribution plans. Defined contribu- tion plans are plans that provide for a separate account for each person covered by the plan. Benefits are based only on amounts contrib- uted to or allocated to each account.

There are three types of defined contribution plans: profit-sharing plans, stock bonus plans, and money purchase pension plans.

Profit-sharing plans. A profit-sharing plan is a plan that enables your employees or their bene- ficiaries to share in the profits of your business. You make contributions to the plan from cur- rent or accumulated earnings. The plan must have a definite predetermined formula for allo- cating the contributions to the plan among the participating employees and for distributing the funds accumulated under the plan.

Stock bonus plan. A stock bonus plan is similar to a profit-sharing plan. However, unlike a profit-sharing plan, your contributions to the stock bonus plan need not depend on your profits. Benefits under the plan are payable in the form of your company's stock.

Money purchase pension plan. Under a money purchase pension plan, your contribu- tions to the plan are based on a predetermined formula, that is not subject to your discretion, such as 10% of each participating employee's compensation. Your contributions to the plan cannot be based on your profits.

Even though a money purchase pension plan is a defined contribution plan, it must meet some of the requirements for defined benefit pension plans to be a qualified employee bene- fit plan.

Defined benefit plans. Defined benefit plans are any qualified employee benefit plans that are not defined contribution plans. In general, a qualified defined benefit plan must provide defi- nitely determinable benefits, and your contribu- tions to the plan must not be based on your profits.

Defined benefit plans include pension plans and annuity plans.

Pension plan. A pension plan is a plan set up to provide systematically for the payment of definitely determinable retirement benefits.

Annuity plan. An annuity plan can also be set up to provide systematically for the payment of definitely determinable retirement benefits. However, a qualified annuity plan does not need to operate through an exempt trust. Under an annuity plan, you purchase annuity or insur- ance contracts covering your employees di- rectly from an insurance company.

Plan approval. The Internal Revenue Service will issue a determination or opinion letter re- garding a plan's qualification. The Service's de-

termination or opinion will be based on how the plan is written, not on how it operates. It is not necessary for you to request such a letter to get all the tax benefits of a plan.

For more information on requesting determination and opinion letters, see Publication 1045, *Filing Requirements for Employee Benefit Plans.*

Master and prototype plans. It may be more convenient for you to adopt an already existing master or prototype retirement plan than to set up your own original plan. Master and prototype plans may be sponsored only by trade or professional organizations, banks, insurance companies, or regulated investment companies. The sponsoring organization usually will have applied for, and received, an opinion letter on the plan form from the National Office of the Internal Revenue Service. This does not mean that your plan is automatically qualified. It must still meet all of the requirements.

Nonexempt Trusts and Annuity Plans

You can deduct contributions made to a nonexempt trust or premiums paid under a nonqualified annuity plan. Your employees must include the contributions or premiums in their gross income generally according to the rules discussed earlier, under *Pay in the Form of Restricted Property* in Chapter 2.

In general, if your employee's interest in the contributions or premiums is transferable or is not subject to a substantial risk of forfeiture, the employee must include the contributions or premiums in gross income.

You deduct your contributions under the plan in the tax year in which any of your employees must include in their gross income an amount attributable to the contributions. You can deduct contributions only if you maintain separate accounts for each participating employee.

Therefore, if an employee's interest in your contributions on that employee's behalf is transferable or if it is not subject to a substantial risk of forfeiture when you make them, the employee must include those amounts in gross income for the tax year in which they are made. However, if, when you make the payments, the employee's interest in the trust or in the value of the annuity contract is not transferable and it is subject to a substantial risk of forfeiture, the employee must include that interest in gross income for the tax year in which the interest becomes transferable or is no longer subject to a substantial risk of forfeiture.

Self-Employed Retirement Plans

You may be entitled to a limited deduction for contributions to a Keogh (HR-10) plan to provide retirement benefits for yourself, either as a sole proprietor or as a partner of a partnership, if you have earned income from personal services that you performed for the trade or business.

You must figure the amount that you can deduct based on whether you have a defined benefit plan or a defined contribution plan. These terms are explained earlier.

You must be self-employed to establish a self-employed retirement plan. You must have net earnings from the trade or business for which the plan is established to take a deduction for contributions to the plan.

Limit on deduction. Generally, a sole proprietor or partner may deduct contributions to a Keogh profit sharing plan of up to $30,000 or 15% of net earnings from the trade or business that has the plan, whichever is less. For tax years beginning after December 31, 1984, your net earnings, before applying the contribution rate, must be reduced by the deduction for contributions made to a qualified plan on your behalf.

This reduction conforms your net earnings base, for figuring contributions on your behalf, to the compensation base for figuring contributions on behalf of participants who are not self-employed. Subtracting contributions from net earnings would be difficult, however, because of unknown amounts (the contribution is both a percentage of net earnings and a deduction reflected in net earnings).

You can provide for this adjustment indirectly by making an appropriate reduction to the rate for deductible contributions (maximum of 15% for a profit sharing plan) called for in the plan. Use the following worksheet to find this adjusted contribution rate.

1) Rate of contribution in plan		%
2) Rate in (1), shown as a decimal, plus 1		
3) Adjusted rate (divide (1) by (2))		%

Example. Under your qualified profit sharing plan, you may contribute up to 15% of your net earnings. Your net earnings from your trade or business (not taking into account any deduction for contributions on your behalf to the plan) are $200,000. Using the worksheet, you figure the adjusted contribution rate as follows:

1) Rate of contribution in plan		15%
2) Rate in (1), shown as a decimal, plus 1		1.15
3) Adjusted rate (divide (1) by (2))		13.0435%

Since 13.0435% of $200,000 ($26,087) is less than $30,000 (the dollar limit), you may contribute to your plan, and deduct on your Form 1040, $26,087.

Setting up the plan. To set up a self-employed retirement plan, you may adopt your own written program, or a written program prepared by certain sponsoring organizations that generally have received from the Internal Revenue Service previous approval of the form of their plan.

If you make a contribution to a qualified plan after the close of your tax year but by the due date of your return, including extensions, you may deduct the contribution for that year.

Additional information on plans for self-employed individuals may be found in Publication 560, *Self-Employed Retirement Plans.*

Individual Retirement Arrangements

You may be able to set up your own individual retirement arrangement (IRA). To be eligible, you generally must have *compensation* that must be included in your income for the year. You can have an IRA whether or not you are a participant in any other retirement plan.

Setting up an IRA. To set up an IRA, you generally must accept a written agreement prepared by either the Internal Revenue Service or certain sponsoring organizations. A principal difference between these arrangements and a self-employed retirement plan is that you, whether an employer or employee, may independently set up your own plan. You, as an employer, also may set up a simplified employee pension. This is an arrangement that includes your employees.

You may deduct contributions to your IRA. In general, the amount you can deduct each year is the least of the following amounts: Your compensation for the year; or $2,000; or the amount actually contributed to your IRA for the year.

Compensation includes wages, salaries, commissions, bonuses, tips, professional fees, self-employment income, and other amounts received for personal services. Net earnings of your trade or business, reduced by deductible contributions on your behalf to self-employed retirement plans, is compensation.

For tax years beginning after 1984, compensation will include any alimony or separate maintenance payments that are included in gross income.

Income from property, such as rental income, interest income, or dividend income, is not compensation. Compensation does *not* include any amount received as a pension or annuity, or as deferred compensation.

Foreign earned income and other amounts that are excluded from gross income are not compensation. For this purpose, the amount of your compensation must be reduced by any foreign earned income exclusion and foreign housing exclusion.

IRA for a nonworking spouse. If you are married and your spouse has no compensation, you may set up separate IRAs for yourself and your spouse. For combined contributions made to these IRAs, you may deduct the least of the following amounts each year:

1) 100% of your compensation or net earnings from self-employment for the tax year, or
2) $2,250, or
3) The amount of cash actually contributed to the IRAs for the year.

However, you need not make equal contributions to the two IRAs, but you may not contribute more than $2,000 to either IRA for any year.

You must file a joint return to claim a deduction for a contribution to your nonworking spouse's IRA.

Additional information for you and your employees may be found in Publication 590, *Individual Retirement Arrangements (IRAs).*

Simplified Employee Pension

A simplified employee pension (SEP) is an individual retirement arrangement, designed to give you an easy way to make contributions toward your employees' retirement plans. Under a SEP, you contribute directly to the individual retirement account or annuity (an IRA) that each employee has set up with a bank, insurance company, or any other organization qualified to sponsor an IRA.

Employer contributions. You can contribute up to $30,000 or 15% of an employee's *compensation*, whichever is less, to each employee's SEP-IRA.

Your employees may also make contributions to an IRA independently of your SEP contributions and take a deduction of up to $32,000 on their tax returns. (This includes up to $2,000 of their IRA contributions, and 15% of their compensation or $30,000 of employer contributions, whichever is less.)

Compensation, for purposes of the 15% of compensation limitation, includes only amounts you pay your employee and does *not* include your SEP contribution to your employee's IRA.

Example. Barry's employer has a SEP for the employees. Barry's total compensation for 1985 (before his employer's SEP contribution) was $20,000. Barry's employer can contribute up to $3,000 (15% × $20,000) to Barry's SEP-IRA. Barry's employer figures the maximum contribution to Barry's SEP-IRA using his compensation of $20,000 (not $23,000).

Allocation formula. You must have a definite written formula for allocating contributions to your employees' SEP-IRAs. The formula must specify:

1) What requirements an employee must meet to share in an allocation, and

2) How to figure the amount to be allocated to each employee.

Contributions may not discriminate. Your contributions must not discriminate in favor of any employee who is:

1) An officer,

2) A shareholder who owns directly or indirectly more than 10% of the value of your stock,

3) A self-employed individual, or

4) Highly compensated.

You must contribute the same proportion of each participating employee's total compensation that does not exceed $200,000.

Example. Ken and Jerry are employees of A. Both participate in A's SEP. Ken's 1985 salary was $220,000 and Jerry's was $40,000. A's written formula requires a contribution of 5% of each participating employee's salary. A's SEP contribution to Jerry's IRA will be $2,000 (5% × $40,000). The contribution to Ken's IRA will be $10,000 (5% × $200,000).

Participation requirements. If you make a contribution to a SEP, you must make a contribution the calendar year for each employee who:

1) Has reached age 25, and

2) Has performed any service for you during the calendar year and during any part of at least 3 of the immediately preceding 5 calendar years.

All eligible employees must participate in your SEP. If an eligible employee does not participate, all other employees are prohibited from participating in a SEP–IRA with you.

Nonresident aliens, employees whose compensation for the year is less than $200, and, in certain cases, employees with a collective bargaining unit can be excluded.

Employees under common control. When applying the participation rules, allocation formula, and nondiscrimination rules, employees of all corporations who are members of a controlled group of corporations are treated as if they were the employees of the same corporation. A similar rule applies to employees of partnerships and sole proprietorships that are under common control.

Withdrawals must be permitted. A SEP must permit your employees to withdraw any amount from their IRAs at any time. However, certain withdrawals may result in the assessing of penalty taxes against the employee. For more information, see Publication 590.

Contributions are nonforfeitable. All payments to your employee's SEP–IRA are nonforfeitable. SEP–IRAs must follow all the usual rules for IRA accounts and annuities discussed in Publication 590.

Social security taxes. You, as an employer, may take into account taxes paid for your share of Federal Insurance Contribution Act (FICA) taxes, and treat them as contributions to a SEP. If you take any part of FICA taxes into account, part of the tax on self-employment income of each owner-employee must also be taken into account as your contribution.

However, you may not take social security taxes into account as contributions to a SEP–IRA for any tax year in which you also maintain a pension, profit-sharing, or stock bonus plan that takes these contributions into account (an integrated plan).

If your share of FICA taxes and the tax on self-employment income is treated as a SEP contribution to meet a percentage allocation, it will not qualify as a deductible SEP–IRA contribution. It is not deductible because you can deduct only cash contributions to employees' IRAs.

Yearly contributions not mandatory. You are not required to make SEP contributions each year. Whether or not a contribution is made is entirely up to you. If you do make a contribution, it must be allocated to all eligible employees.

Deduction of employer contributions. Your deduction for contributions to a SEP is based on employee compensation for a calendar year. If you use a calendar year, you can deduct contributions made during that calendar year for that year.

Amounts contributed no later than 3½ months (April 15th) after the close of a calendar year can be treated as if contributed in the calendar year. You should designate that the contributions are for the earlier calendar year.

Example. For calendar year 1985, A, an employer, could make a contribution to the SEP-IRAs of its employees through April 15, 1986. A should inform the trustees or custodians of its employees' IRAs that its contributions are for calendar year 1985.

Fiscal year employers can deduct contributions made for the calendar year that ends during their tax year. They must still make contributions no later than 3½ months after the close of that calendar year.

Effect on other pension plans. The amounts contributed to a SEP–IRA of an employee reduce the amount you may deduct on behalf of that employee to other qualified plans. This rule also applies to plans maintained for self-employed individuals and shareholder-employees.

Excess contributions. For any tax year, you may not deduct more than 15% of the compensation paid to your employees during the calendar year that ends within or at the same time as your tax year.

Any excess amount (amount contributed over the amount deductible) must be deducted in the following year(s) using the same 15% yearly limitation, until all excess contributions have been deducted. Publication 590 contains additional information on the withdrawal by employees of excess contributions made to a SEP-IRA.

Income and deductions—employees. Your employees must include your contributions to their SEP–IRAs in their income for the calendar year for which you make the contributions. They can usually deduct from their gross income the amount you contributed to their SEP–IRAs. Even if they cannot deduct the contributions, they must include them in income. For more information on how employees should treat contributions to SEP–IRAs, see Publication 590, *Individual Retirement Arrangements (IRAs).*

FICA and FUTA taxes. Your contribution to an employee's SEP–IRA is not subject to FICA and FUTA taxes if, at the time of the contribution, it was reasonable to believe that the employee was entitled to deduct the contribution on his or her tax return.

Form W–2. You report your contributions to a SEP–IRA on Form W–2, *Wage and Tax Statement.* You must notify participating employees in writing of the amount contributed so that they may properly treat this amount on their 1985 tax returns.

Any contribution made for a year after the Form W–2 for that year is issued must be shown on an additional W–2.

Reporting requirements. If you decide to set up a SEP, you have few reporting requirements. The purpose in setting up SEPs was to make it easier for employers to provide a pension arrangement without having to file a lot of forms.

Form 5305–SEP. You may set up a SEP by using Form 5305–SEP, *Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement,* and give a copy to each participating employee. Do ***not*** file this form with the Internal Revenue Service. It is an agreement by you that you will contribute to your employee's SEP–IRA according to the terms and conditions that are in the agreement.

Form 5305–SEP includes instructions to employers for executing and implementing a plan, as well as questions and answers to explain the tax effects of a plan and how it works. You must give all this information to participating employees.

You must give each employee a copy of the filled-out Form 5305–SEP. Each year you must also give each participating employee a statement showing how much you contributed to the employee's SEP–IRA for the year.

The agreement obligates you to transfer any allocation made to each employee's SEP–IRA (whether administered by a trustee, custodian, or insurance company) according to the formula in the agreement, and include these amounts in the employee's gross income on Form W–2.

Disclosure requirements for a SEP–IRA require the disclosure of information contained on Form 5305–SEP in addition to that pertaining to any other IRA. See Publication 590 for a more complete explanation of the disclosure requirements.

Contributions made by employers using Form 5305–SEP may be made to an employee's IRA that is a model IRA from Form 5305, *Individual Retirement Trust Account,* or Form 5305–A, *Individual Retirement Custodial Account,* or a master or prototype IRA that has received a favorable opinion letter from the Internal Revenue Service.

Additional information. For more information on IRAs in general and how employees must treat contributions to their SEP–IRAs, see Publication 590.

Filing Requirements

For information on the forms that must be filed for retirement plans, see Publication 1048, *Filing Requirements for Employee Benefit Plans.*

You should receive Form 5498, *Individual Retirement Arrangement Information,* or an annual statement from plan sponsors, showing all the contributions made to your IRA 1985.

4. Rent Expense

If you lease business property, you generally may deduct the rent you pay. You may also deduct certain other expenses as rent. This chapter explains when you may take these deductions.

Rent

Rent is the amount that you have to pay for the use of property that you do not own. In general, you may deduct rent as an expense only if the rent is for property that you use in your trade or business. If you have or will receive equity in or title to the property, the rent is not deductible.

Rent on a personal residence. If you use part of your home as your place of business, you may be able to deduct the rent you pay for that part. For more information, see Publication 587, *Business Use of Your Home.*

Rent paid in advance. If you pay rent in advance, you may deduct only the amount that applies to your use of the rented property dur-

ing that tax year. The rest may be deducted only over the period to which it applies.

Example 1. In May 1985, you leased a building for 5 years, beginning July 1, 1985, and ending June 30, 1990. Under the terms of the lease, your rent is $12,000 per year. You paid the first year's rent ($12,000) on June 3, 1985. On your income tax return for calendar year 1985, you may deduct only 6/12 of $12,000, or $6,000, for the rent applicable to 1985.

Example 2. In January 1985, you leased property for 3 years for $6,000 a year. You paid the full $18,000 (3 × $6,000) during the first year of the lease. For 1985, you may deduct only $6,000, that part of rent that applies to 1985. You must deduct the balance ($12,000) over the remaining 2 years, $6,000 each year.

Lease or purchase. To determine if you may deduct payments as rent, you must first determine if your agreement is a lease or a conditional sales contract. If under the agreement you acquired, or will acquire, title to or equity in the property, the agreement should be treated as a conditional sales contract. Payments made under a conditional sales contract are not deductible. However, see *Finance leases*, later in this chapter.

Whether the agreement is a lease or a conditional sales contract depends upon the ***intent of the parties.*** Intent is determined based upon the facts and circumstances existing at the time the agreement is made.

Determine the intent. An agreement may be considered a conditional sales contract rather than a lease if any of the following is true:

1) The agreement applies part of each "rent" payment toward an equity interest that you will receive.
2) You get the right to buy the property after making all the required payments.
3) You must pay over a short period of time compared to the useful life of the property, an amount that is close to the price of the property and can continue to use the property for periods approximating its useful life for nominal payments, even if title does not pass.
4) You pay rent that is much more than the current fair rental value for the property.
5) You have an option to buy the property at a price that is small compared to the value of the property at the time you may take advantage of the option. Determine this value at the time of the agreement.
6) You have an option to buy the property at a price that is small compared to the total amount you are required to pay under the lease.
7) The lease designates some part of the "rent" payments as interest, or part of the "rent" payments are easy to recognize as interest.

Example. Sally Jones leased a sprinkler system for her warehouse. The system had an estimated useful life of 40 years. Under the lease Sally will rent the system for 5 years at a yearly rate of $400, for a total rent of $2,000 representing the total cost of the system. Sally must insure the system for an amount at least equal to the total rentals and bears the risk of any loss. The lessor's liability for any defect in the system is limited to $100. Sally may renew the lease for another 5-year period at $20 a year.

This arrangement is really a conditional sale, not a lease. Sally may not deduct the payments as rent, but she may deduct the part of the payments that is applied to interest, insurance, repairs, and maintenance charges. She must capitalize the balance of the payments and treat them as costs of acquiring the sprinkler system.

Leveraged leases. Leveraged leases generally involve three parties: a lessor, a lessee, and a lender to the lessor. Usually the lease covers a large part of the useful life of the leased property, and the lessee's payments to the lessor are enough to cover the lessor's payments to the lender.

If you plan to take part in what appears to be a leveraged lease, you may want to get an advance ruling. Revenue Procedure 75-21, 1975-1 C.B. 715, as modified by Revenue Procedure 79-48, 1979-2 C.B. 529, contains the guidelines used for an advance ruling to determine if a leveraged lease is a lease for federal income tax purposes. Some of these guidelines are:

1) The lessor must risk a minimum unconditional investment in the property during the entire lease;
2) The lessee may not have a contractual right to buy the property from the lessor at less than fair market value at the time the right is exercised;
3) The lessee may not invest in the property, except as provided by Revenue Procedure 79-48;
4) The lessee may not lend any money to the lessor to buy the property; and
5) The lessor must have a profit motive.

To file for an advance ruling, follow the instructions in Revenue Procedure 75-28, 1975-1 C.B. 752, as modified by Revenue Procedure 79-48, 1979-2 C.B. 529.

Leveraged leases of limited use property. The Internal Revenue Service will not issue advance rulings on leveraged leases of so-called limited use property. Limited use property is property not expected to be either useful to or usable by a lessor at the end of the lease term except for continued leasing or transfer to a member of the lessee group. See Revenue Procure 76-30, 1976-2 C.B. 647 (as modified by Revenue Procedure 81-71, 1981-2 C.B. 731) for examples of property that is limited use property and property that is not limited use property.

Finance leases. The rules discussed above—those used to decide whether an agreement is a lease or a sale—do not apply to all agreements. There are some agreements, known as "finance leases," that come under different rules. If an agreement qualifies as a finance lease, the agreement is treated as a lease for federal tax purposes even if it has some elements of a sale. These rules provide a guarantee that the agreement will be treated as a lease.

Application of the rules for finance leases, which generally replaced the rules for safe harbor leases for agreements entered into after 1983, is delayed. The finance lease rules generally will not apply to agreements entered into before January 1988. However, the finance lease rules continue to apply as they have since July 2, 1982, to certain leases of farm property.

For more information on certain leases of farm property, see Publication 225, *Farmer's Tax Guide.*

Taxes on Leased Property

If you lease business property, you may deduct as additional rent taxes that you have to pay to or for the lessor. When you may deduct the real estate taxes that you pay on leased property depends on your accounting method.

Cash method. If you use the cash method of accounting, you may only deduct the taxes as additional rent for the tax year in which you pay them.

Accrual method. If you use the accrual method of accounting, you may deduct the taxes as additional rent for the tax year in which you are able to determine that you have a liability, how much it is, and when economic performance occurs (the economic performance rule is discussed under *When Can an Expense Be Deducted?* in Chapter 1). This is generally determined by state or local law, and also by the lease agreement.

Example. Oak Corporation is a calendar year taxpayer that uses the accrual method of accounting. Oak leases land for use in its business. Under local law, owners of real property become liable (it becomes a lien on the property) for real estate taxes for the year on January 1 of that year, but do not have to pay these taxes until June 1 of the next year (18 months later). This means that property owners become liable for 1984 real estate taxes on January 1, 1984, but do not have to pay them until June 1, 1985.

Under the terms of the lease, Oak becomes liable for the real estate taxes when the tax bill are issued on June 1, 1985. Oak may not deduct the real estate taxes for 1984 as additional rent until June 1, 1985, when Oak's liability under the lease becomes fixed.

If, under the terms of the lease, Oak is liable for the real estate taxes when the owner of the property becomes liable for them, on January 1, 1984, but does not have to pay them until June 1, 1985, Oak will deduct the real estate taxes as rent on its 1984 income tax return, the year in which Oak's liability under the lease becomes fixed.

Cost of Acquiring a Lease

You may either enter into a new lease with the lessor of the property or acquire an existing lease from another lessee. Very often when you acquire an existing lease from another lessee, in addition to paying the rent on the lease, you must pay the previous lessee a sum of money to acquire that lease.

If you acquire an existing lease on property or equipment for your business, you must amortize any amount you pay to acquire that lease over the remaining term of the lease. For example, if you pay $10,000 for an existing lease on a machine and there are 10 years remaining on the lease, you may deduct $1,000 each year.

Term of the lease. To figure how much of the lease acquistion costs you may deduct each year, you must determine the term of the lease.

Option to renew. In general, the term of the lease is the period of time covered by the lease. A lease may have a base period plus periods when the lessee has the choice of renewing, extending, or continuing the lease. If you acquire a lease that has optional renewal periods, part of the cost of acquiring the lease is for the base period and part is for the renewal periods. However, the term of the lease for amortization purposes will include these renewal periods if the cost of acquiring the base period is less than 75% of the total cost to acquire the lease.

You may exclude any renewal period if you can show that it is likely that the lease will not be renewed. However, you must include the renewal periods if the facts show that the lease will be renewed.

Example 1. You paid $10,000 to acquire a lease with 20 years remaining on it and two options to renew for 5 years each. Of this cost, $7,000 was paid for the original lease and $3,000 was applied to the renewal options. Since $7,000 is less than 75% of the total cost of the lease of $10,000, you must amortize the

00 over 30 years, the remaining life of
present lease plus the periods for renewal.

ample 2. In Example 1, if the amount appli-
to the original lease had been $8,000,
you would be allowed to amortize the en-
10,000 over the 20-year remaining life of
riginal lease because the $8,000 cost of
ring the original lease is not less than 75%
total cost of the lease.

of a modification agreement. If you have
y additional "rent" over part of the lease
d in order to change certain provisions in
lease, you must capitalize these payments
amortize them over the remaining period of
ease. You may not deduct the payments as
ional rent, even if they are described as
in the agreement.

ample. You sign a 20-year lease to rent
of a building. However, before you occupy
u decide that you really need less space.
lessor agrees to reduce your rent from
00 to $6,000 per year and to release the ex-
space from the original lease. In ex-
nge, you agree to pay $3,000 in additional
payable in 60 monthly installments of $50
n.

ou must capitalize the $3,000 and amortize
er the 20-year term of the lease. Your
rtization deduction each year will be $150
000 ÷ 20). You may not deduct the $600
you will actually pay during each of the
5 years as rent.

mmissions, bonuses, and fees. Commis-
s, bonuses, fees, and other amounts that
pay to obtain a lease on property you use
our business are capital costs. You must
rtize these costs over the life of the lease.

s on merchandise and fixtures. If you sell at
ss merchandise and fixtures that you
ght solely to acquire a lease, the loss is a
t of acquiring the lease. You must capitalize
loss and amortize it over the remaining life
he lease.

proved leased property. If you lease property
n a building or other improvement already
it, you are entitled to amortize only your cost
acquiring the lease. You may not claim a de-
ction for depreciation on the building or
er improvements.

mprovements by Lessee

f you lease property and you add buildings
make other permanent improvements to it,
u may be able to either depreciate or amor-
e the improvements.

preciation. If the useful life of the improve-
nt is equal to or less than the remaining
m of the lease, you may depreciate the im-
ovement over the estimated useful life of the
provement.

Recovery property. If the improvement is re-
very property and its recovery period is equal
or shorter than the term of the lease, you
ould depreciate it over its recovery period in-
ead of its useful life. For a discussion of re-
very property and methods of depreciation,
e Publication 534.

mortization. If the useful life of the improve-
ent is longer than the remaining term of the
ase, then you may amortize the cost of the
provement over the remaining term of the
ase.

Recovery property. If the improvement is re-
overy property, use its recovery period to de-
de whether you must amortize it over the
maining term of the lease. If the recovery pe-
od is longer than the remaining term of the
ase, you must amortize the cost of the im-
rovement over the remaining term of the
ase. If you choose to use straight-line recov-
ry for the property, the recovery period you compare with the lease term is the recovery period you choose with that method of recovery. For more information on recovery property, see Publication 534.

Term of the lease. If you can show that the lease will not be renewed, you may exclude any renewal period when you figure the term of the lease. However, if the facts show that it is likely that the lessor will renew the lease, then you must include the renewal periods when figuring whether to amortize or depreciate the improvement.

If you are assigned a lease. If a long-term lessee who made permanent improvements to leased land assigned to you all rights to that lease for a sum of money, and if you must pay the rent required by the lease, the amount you pay for the assignment is a capital investment. Part of this capital investment may be for an increase in the rental value of the leased land, and the rest for your investment in the permanent improvements.

The part that is for the increased rental value of the leased land is a cost of acquiring a lease and you must amortize it over the period of the lease. You can either depreciate or amortize the part that is for your investment in the building as discussed earlier under *Depreciation* and *Amortization*.

Example 1. In 1984 Frank Jones leased unimproved property for 99 years and built a warehouse on it. In January 1985, immediately after the building was completed, Frank assigned all his rights in the lease to you. You paid Frank $100,000 for the assignment, and you also agreed to pay to the lessor the rent under the lease. The $100,000 you paid Frank is considered paid for the warehouse, which you may capitalize and depreciate.

Example 2. Assume that in Example 1 Frank had leased the property, built the warehouse in 1969, and used it in his business until he assigned the lease to you in January 1985. The rental value of the unimproved land for the remaining period of the lease increased $40,000 since the time the lease was entered into in 1969. Of the $100,000 that you paid to Frank, $40,000 is considered to have been paid for the lease, and follows the rules explained earlier under *Cost of Acquiring a Lease*. Treat the balance of $60,000 as having been paid for the warehouse. You may capitalize it and depreciate it or amortize it as discussed earlier under *Depreciation* and *Amortization*.

5. Interest

Interest is the charge made for the use of borrowed money. You may deduct all interest you pay or accrue in the tax year on a debt that is related to your trade or business. The interest must be on a debt under which you have a valid obligation to pay a fixed or determinable sum of money.

To deduct the interest paid, you must be liable for its payment. For example, you may not deduct interest paid on a corporation's debt on your individual return.

What Is Deductible

Generally, the amount agreed upon by the lender and the borrower as interest may be deducted when paid or accrued. Both parties must intend that the loan will be repaid.

Insurance contracts. If you borrow on your life insurance, endowment, or annuity contract and use the proceeds for business purposes, you may take a business interest deduction. But, if you use the proceeds for a nonbusiness purpose, you may deduct the interest only as an itemized deduction on Schedule A (Form 1040). See Publication 545, *Interest Expense*.

Mortgages. Monthly mortgage payments are usually made up of principal and interest. You may deduct only the interest. If you paid mortgage interest of $600 or more during the year on any one mortgage to a mortgage holder (including a financial institution, a governmental unit, and a cooperative housing corporation) in the course of that holder's trade or business, you will receive Form 1098, *Mortgage Interest Statement*, or a similar statement.

Prepayment penalty. If you pay off your mortgage early and pay the lender a penalty for doing this, you may deduct the penalty as interest.

Points. The term "points" is often used to describe some of the charges paid by a borrower when the borrower takes out a loan or a mortgage. These charges are also sometimes called ***loan origination fees***, maximum loan charges, or premium charges. If any of these charges is solely for the use of money, it is interest. However, it is treated like prepaid interest, and you may not deduct it all in one tax year. Instead, you may deduct some of this interest in each tax year during the period of the loan.

To figure how much to deduct in each tax year, divide the part of the loan period falling within your tax year by the total loan period. Then multiply this answer by the amount of prepaid interest. For example, if you take out a 10-year loan on November 1, 1985, so that only 2 months of the loan period fall in your 1985 tax year, in 1985 you could deduct just 2/120 of the payment that you made for "points" constituting prepaid interest when you got the loan. In 1986 you could deduct 12/120 of the prepaid interest.

Expenses paid to get a mortgage. Other expenses you pay to get a mortgage may not be deducted as interest. These expenses, which include mortgage commissions, abstract fees, and recording fees, are capital expenditures. However, they are not capital expenditures that you add to the basis of your property. If the property mortgaged is business or income-producing property, you may amortize these costs over the life of the mortgage.

To figure your amortization deduction for a tax year, divide the part of the loan period that falls in your tax year by the total loan period. Then multiply the answer by the total amount of the expenses you paid to get the mortgage.

Unstated interest. If no interest or low interest is charged on certain installment purchases, an amount of unstated interest is considered to be included in the payments you make. See Publication 537, *Installment Sales*.

Construction period interest. Construction period interest is interest on a debt to acquire, build, or carry real property for the time it takes to build improvements on the property. You must capitalize this interest, but you may take amortization deductions for it. See Chapter 9, *Amortization*, for more information on this topic.

What Is Not Deductible

Some interest payments may not be deducted. In addition, certain expenses that seem to be interest are not interest and are not deductible as interest.

Cash or equivalent. Interest is not deductible by a cash method taxpayer unless it is paid in cash or its equivalent. Therefore, if you are a cash method taxpayer and you pay interest with funds you got from the original creditor through a second loan, an advance, or any other arrangement similar to a loan, you may not deduct it.

Capitalized interest. Some interest expenses that you capitalize may not be deducted as interest.

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If you buy property and pay interest owed by the seller, you may not deduct the interest. You should add the interest to the basis of the property. See *Carrying Charges* in Chapter 8 for more information on this topic.

Costkeeping. Do not deduct interest that you figure for costkeeping or other purposes related to a capital or surplus amount invested in the business and that is not a charge on an interest-bearing obligation.

Commitment fees or standby charges. Fees that you incur to have business funds made readily available to you over a period of time, but not for the actual use of the funds, are not interest payments. If you borrow the funds, these fees are a cost of getting your loan, and you may deduct a part of the fees in each tax year during the period of the loan. To figure your deduction for each tax year, divide the part of the loan period falling within the tax year by the total loan period. Then multiply this answer by the total amount of the fees. If you do not take out a loan, you may be allowed to take a loss deduction for these fees when your right to borrow the funds expires.

Income tax owed. Interest paid or accrued on an income tax deficiency assessed on your individual income tax return is not a business deduction even though the deficiency is related to income from your trade or business. This interest is treated as a business deduction only in figuring a net operating loss deduction.

Penalties. Penalties on deficiencies and on underestimating tax are not interest and may not be deducted. Fines and penalties are generally not deductible.

Interest relating to tax-exempt income. Generally, interest relating to tax-exempt income is not deductible. No deduction is allowed for:

1) Interest on a debt incurred to buy or carry tax-exempt securities,
2) Amounts paid or incurred in connection with personal property used in a short sale, or
3) Amounts paid or incurred for the use of any collateral used in a short sale.

If you provide cash as collateral in a short sale and receive no material earnings on the cash during the period of sale, item (2) above does not apply. For more information on short sales, see Publication 544, *Sales and Other Dispositions of Assets.*

Limit on investment interest. If you paid or accrued interest on money that you borrowed to buy or carry property held for investment (including amounts allowable as a deduction in connection with personal property used in a short sale), your deduction for this interest may be limited. The limit applies to all noncorporate taxpayers. It applies to S corporations and partnerships at the shareholder and partner levels. Your deduction may be limited if your investment interest expense is more than $10,000 ($5,000 if you are married and you file a separate return). However, no limit applies to your deductions for personal or business interest expenses.

Form 4952. If your investment interest expenses for the year total more than $10,000 ($5,000 if you are married and file separately), complete Form 4952, *Investment Interest Expense Deduction,* to figure your allowable deduction.

For more information on the limit on the investment interest expense deduction, see Publication 550, *Investment Income and Expenses.*

When To Deduct

Generally, if you use the cash method of accounting, you may deduct interest only in the year you pay it. If you use the accrual method of accounting, you deduct interest in the year it accrues. Under this method, your deduction for interest depends on when economic performance occurs. The economic performance rule is dicussed under *When Can an Expense Be Deducted?* in Chapter 1.

Cash method. You may deduct only payments of interest that you actually made during the tax year. A promissory note you give as payment of interest is not deductible because it is a promise to pay and not an actual payment.

Prepaid interest. Under the cash method, you may not deduct any interest that is paid before the year it is due. An advance payment is treated as paid in the period that is covered by the prepaid interest.

Discounted loans. If interest or a discount is subtracted from your loan proceeds, it is not payment of interest and you may not deduct it when you get the loan. A cash method taxpayer must prorate this discount over the loan period and may deduct interest only when payments are made on the loan.

Accrual method. You may deduct only interest that has accrued economically during the tax year.

If in past years you have taken an interest deduction figured under the rule of 78's method, you may have to make a change in the way you figure your interest deduction. See Publication 545, *Interest Expense* for more information.

Prepaid interest. If you pay interest in advance, you deduct it as it accrues over the period of the debt. This rule also applies to the amount subtracted on a ***discounted loan.***

Payments unlikely to be made. If interest payments are unlikely to be made because of your financial difficulty, you may still take a deduction for accrued interest.

Tax deficiency. Interest on a federal income tax deficiency asserted against a corporation accrues in the tax year the liability is finally determined if the deficiency was contested. If the deficiency is not contested, interest accrues in the year it was asserted and agreed to. Interest is deducted in the year it accrues.

Related taxpayer. If you use the accrual method, you cannot deduct interest owed to a related cash basis person, ***until*** payment is made and the interest is includible in the gross income of that person. The relationship, for puposes of this rule, is determined as of the end of the tax year for which the interest would otherwise be deductible. If a deduction is denied under this rule, the rule will continue to apply even if your relationship with the person ceases to exist before the interest is includible in the gross income of that person.

However, you may deduct the amount if you pay it within 2 months after the end of your tax year, if the amount is paid (1) on indebtedness incurred on or before September 29, 1983, or (2) under a contract binding on September 29, 1983, and thereafter before the amount is paid or incurred. See the definition of related taxpayers in Chapter 2 under *Unpaid Salaries.*

Proportionate share. If you are liable for part of a debt, you may deduct only your share of the total interest paid or accrued.

Example. You and your brother borrow money. You are liable for 50% of the note. You use your half of the loan in your business, and you make one-half of the loan payments. You may deduct your half of the total interest payments as a business deduction.

Partial payments. If you make partial payments on a nontax debt, the payments, in the absence of any agreement between you and the lender, are applied first to interest and any remainder to principal. You may deduct only the amount that is interest. If you are insolvent, the value of property transferred to satisfy your debts will be applied first to principal and then to interest.

Refunds of interest. If you are a cash method taxpayer who pays interest and then receives a refund for any part of the interest in the same tax year, reduce your interest deduction by the amount of the refund. If you receive the refund in a later tax year, include the refund in income. However, if part of the deduction for the interest did not reduce your income subject to tax, you do not have to include all of the refund in income. Exclude an amount equal to the part that did not reduce your income subject to tax.

Below-Market Interest Rate Loans

A ***below-market loan*** is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. A below-market loan is generally treated as an arm's-length transaction in which the lender is deemed (1) to have made a loan to the borrower in exchange for a note that requires the payment of interest at the applicable federal rate, and (2) to have made a payment to the borrower. The lender's payment to the borrower is treated as a gift, dividend, contribution to capital, payment of compensation, or other payment, depending on the substance of the transaction.

Gift and demand loans. In the case of below-market gift demand loans and other demand loans (loans payable in full at any time upon the lender's demand), the lender is treated as transferring (as a gift, dividend, etc.) the foregone interest to the borrower. The borrower is treated as transferring the foregone interest to the lender and may, therefore, be entitled to deduct the amount as interest expense. The lender must report this amount as interest income. These transfers are deemed to occur annually, generally on December 31. The amount of foregone interest is determined under section 7872 (e)(2) of the Internal Revenue Code.

Term loans. In the case of below-market term loans (loans that are not demand loans), the lender is treated as transferring (as a gift, dividend, etc.) a lump-sum cash payment to the borrower on the date the loan is made. The amount transferred is the excess of the amount of the loan over the present value of all payments due under the loan. In addition, an amount equal to this excess is treated as original issue discount. Accordingly, the original issue discount rules of section 1272 of the Internal Revenue Code apply. See *Original Issue Discount* in Publication 550, *Investment Income and Expenses.*

In the case of a ***gift term loan,*** the amount treated as transferred by the lender to the borrower is determined using the rules for term loans, discussed above. The amount of foregone interest treated as transferred by the borrower to the lender as interest income, however, is determined using the rules for demand loans, discussed above.

Loans subject to the rules. The rules for below-market loans apply to:

1) Gift loans
2) Compensation-related loans
3) Corporation-shareholder loans
4) Tax avoidance loans
5) Other below-market loans
6) Loans to qualified continuing care facilities (made after October 11, 1985)

Exceptions. Various exceptions and limits apply to below-market loans:

1) The *de minimis* exception for gift loans between individuals applies, if the total of out-

standing loans between the borrower and the lender does not exceed $10,000. This exception does not apply if the loan is directly attributable to the purchase or carrying of income-producing assets.

) The *de minimis* exception for compensation-related loans and corporation shareholder loans applies, if the total of direct or indirect outstanding loans between the borrower and the lender does not exceed $10,000. This exception does not apply if a principal purpose of the interest arrangement is to avoid federal tax.

) Special rules apply for gift loans between individuals that do not exceed $100,000. The amount of foregone interest, treated as transferred by the borrower to the lender, is limited to the borrower's net investment income for the year. Furthermore, if a borrower has net investment income of $1,000 or less for the year, the borrower's net investment income is deemed to be zero.

Loans not subject to the rules. Some loans are specifically excluded from the rules for below-market loans, such as:

1) Loans made available by lenders to the general public on the same terms and conditions,
2) Loans subsidized by the federal, state, or municipal government that are made available under a program of general application to the public,
3) Certain employee-relocation loans,
4) Loans to charitable organizations, if the aggregate amount of all loans by the lender to all such organizations is not more than $10,000 at any time during the year,
5) Loans made by a private foundation for certain nonprofit purposes,
6) Certain loans from a foreign lender, unless the interest income imputed to the lender would be effectively connected with the conduct of a U.S. trade or business and not exempt from U.S. tax under an income tax treaty, and
7) Loans if the taxpayer can show that the interest arrangements have no significant effect on the federal tax liability of the lender or the borrower.

However, if one of the principal purposes of structuring a transaction as an exempted loan is the avoidance of federal tax, the loan will be considered a tax avoidance loan and will be subject to the rules for below-market loans.

Certain loans to qualified continuing care facilities. The rules for below-market loans do not apply to any loan made prior to October 12, 1985, to any qualified continuing care facility pursuant to a continuing care contract. Beginning October 12, 1985, the rules for below-market loans will not apply for any calendar year to any loan made by a lender to a qualified continuing care facility under a continuing care contract (defined below) if the lender (or the lender's spouse) reaches age 65 before the end of the year, to the extent that the aggregate outstanding amount of any such loan when added to the aggregate outstanding amount of all other previous such loans between the lender (or the lender's spouse) and any qualified continuing care facility does not exceed $90,000.

A **qualified continuing care facility** is one or more facilities which are designed to provide services under continuing care contracts, and substantially all of the residents are covered by continuing care contracts.

A **continuing care contract** is a written contract between an individual and a qualified continuing care facility under which the individual or individual's spouse may use a qualified continuing care facility for their life or lives. The individual or individual's spouse must first reside in a separate independent living unit with additional facilities outside the unit for the providing of meals and other personal care and not require long-term nursing care. Then, the individual or individual's spouse will be provided long-term and skilled nursing care as the health of the individual or individual's spouse requires. The contract must provide that no additional substantial payment is required if the individual or individual's spouse requires increased personal care services or long-term and skilled nursing care.

Effective dates. Except as provided above, these rules apply to term loans made after June 6, 1984, and to demand loans outstanding after that date.

For more information, see sections 7872 of the Internal Revenue Code and 1.7872–5T of the regulations.

6. Taxes

You may deduct various taxes imposed by federal, state, and local governments if you incur them in the ordinary course of your trade or business and if they are directly attributable to that trade or business.

For the purpose of deducting taxes, Indian tribal governments that are recognized by the Secretary of the Treasury as exercising sovereign powers are treated as states. You may also deduct taxes imposed by any subdivision of an Indian tribal government if the Secretary of the Treasury recognizes the subdivision as having been delegated the right to exercise one or more sovereign powers of the Indian tribal government. Sovereign powers include the power to tax, the power of eminent domain, and police power, such as control over zoning, police protection, and fire protection.

If you use the cash method of accounting, you may deduct taxes only in the year paid. If you use the accrual method, you may deduct them only in the year they are properly accrued. Under the accural method, your deduction for taxes may depend on when economic performance occurs. The economic performance rule is discussed under *When Can an Expense Be Deducted?* in Chapter 1.

Federal income, estate, and gift taxes, and state inheritance, legacy, and succession taxes are not deductible.

Refunds of taxes. If you use the cash method of accounting and you receive a refund for any part of taxes you deducted in an earlier year, include the refund in income. However, if part of the deduction did not reduce your income subject to tax, you do not have to include all of the refund in income. Exclude an amount equal to the part that did not reduce your income subject to tax.

Real Estate Taxes

Real estate (real property) taxes are the taxes you pay on real property that you own. Ordinarily, you may deduct them, but sometimes you may elect to capitalize expenditures for taxes as part of the cost of property. Sometimes you ***must*** capitalize expenditures for real property taxes.

Assessments for local improvements that tend to increase the value of your property, such as assessments for construction of streets, sidewalks, and water and sewerage systems, or to provide public parking facilities, generally are not deductible. If the local improvement increases the value of your property, you must capitalize the assessment.

Local assessments for maintenance, repairs, or interest charges for benefits such as streets, sidewalks, and water and sewerage systems are deductible. If only part of the assessment is for maintenance, repairs, or interest, you must be able to show the amount so allocated. If you cannot determine what part of the assessment is for maintenance, repairs, or interest, none of it is deductible.

Water bills, sewerage, and other service charges assessed against your business property are deductible as business expenses.

Example. City X, to improve downtown commercial business, converted a downtown business area street already improved by lights, sidewalks, sewers, etc., into an enclosed pedestrian mall. The full cost of construction, financed with 10–year bonds, was assessed against the affected properties. Payments of principal and interest made annually for 10 years, which is also the period of expected business advantage, are required from the property owners. The assessments incurred by the property owners are not deductible as taxes, or as business expenses, but are depreciable capital expenditures. Only the part of payments that is to pay interest charges on the bonds is deductible as taxes.

If real estate is sold, the deduction for real estate taxes must be divided between the buyer and the seller according to the number of days in the ***real property tax year*** (the period to which the tax imposed relates) that each held the property. The taxes are apportioned to the seller up to but not including the date of sale, and to the buyer beginning with the date of sale, regardless of the accrual or lien dates under local law.

If you use the cash method and cannot deduct taxes until paid, and if the buyer of your property is personally liable for the tax, you are considered to have paid the part of the tax imposed for the part of the year up to the time of the sale. This permits you to deduct the part of the tax to the date of sale even though you do not actually pay it.

If you use the accrual method and have not elected to ratably accrue real property taxes, the taxes apportioned to you (but not deductible for any year under your accounting method) accrue on the date of sale.

Example. Al Green, a calendar year accrual method taxpayer, owns real property in X county but has not elected to ratably accrue property taxes. November 30 of each year is the assessment and lien date. He sold the property on June 28, 1985, and under his accounting method would not be able to claim a deduction for the taxes because the sale occurred before November 30. The part of the 1985 tax apportioned to him, 178/365 (January 1 – June 27), is treated as having accrued on June 28, and is deductible for 1985.

Election to ratably accrue. An accrual method taxpayer may elect to accrue real property tax that is related to a definite period of time ratably over that period of time.

Example. Al Red is a calendar year taxpayer who is on the accrual method and whose real property taxes applicable to the fiscal year July 1, 1985, to June 30, 1986, amount to $1,200. The assessment and lien date is July 1. If for 1985 Al makes the election to ratably accrue the taxes, $600 of the taxes will accrue in 1985 ($1,200 times 6/12, July 1—December 31) and the balance will accrue in 1986. The 1985 taxes for January to June 30 accrued on July 1, 1984, and were deductible for 1984.

An election may be made by the taxpayer for each separate trade or business and for nonbusiness activities if accounted for separately.

The election to ratably accrue real property taxes is binding on the taxpayer unless the

consent of the Commissioner is obtained to change the method of deducting real property taxes.

Any real property taxes that normally are deductible for the tax year, and that apply to periods prior to the year of the election, are deductible for the tax year in which you make the election.

Making the election. If you make your election for the first year in which real property taxes are incurred, the election may be made in a statement attached to your income tax return for that year. The return must be filed by the regular due date (including extensions). The statement should indicate:

1) The trades or businesses to which the election applies and the accounting method or methods used,
2) The period of time to which the taxes relate, and
3) The computation of the real property tax deduction for the first year of election.

For any other year, you must secure consent of the Internal Revenue Service to make the election for the change. To secure consent, complete Form 3115, *Application for Change in Accounting Method*, which may be obtained from the Internal Revenue Service. This form should be filed within 180 days after the beginning of the tax year for which the election is to be effective. It should be filed with the Commissioner of Internal Revenue, Attention—*CC:C:C*, Washington, DC 20224, in addition to the information previously indicated, the request must set out the following:

1) Your name and address,
2) The tax year of election, and
3) A full description of the manner in which prior years' deductions were determined.

Limitation on accrual of taxes. A taxing jurisdiction can require the use of an earlier date for accruing taxes than that which it previously required. However, the accrual date for federal income tax purposes is the date on which the tax would have accrued had no action been taken.

State and Local Income Taxes

State income taxes imposed on a corporation are deductible by the corporation. However, state income taxes are not deductible by an individual as expenses of the business, but may be deducted in computing the individual's income tax liability if deductions are itemized.

A state tax on gross income (as distinguished from net income) directly attributable to a trade or business carried on by an individual or a partnership is deductible as an expense of the business.

Accrual of additional state income taxes. If an accrual method is used and liability is contested, any increase in such deductible business taxes for an earlier year will accrue and be deductible in the year the amount is finally determined.

Filing a state tax return is not considered contesting a liability for additional state income taxes assessed against taxpayers for prior years. Therefore, in the absence of some objective act of protest or affirmative evidence of denial of liability by an accrual-method taxpayer, any additional state taxes assessed for prior years relate to the year for which they were originally imposed.

Employment Taxes

As an employer, you are responsible for withholding and paying certain taxes in connection with the salaries, wages, fees, certain fringe benefits, and other compensation of your employees. The most common are the social security tax under the Federal Insurance Contributions Act (FICA), the unemployment taxes under the Federal Unemployment Tax Act (FUTA), and the federal income tax.

You should deduct as salary the gross amount you pay an employee, which includes the taxes withheld by you. For example, if you pay an employee $6,000 a year in gross salary but the employee actually receives $7,200 net after deductions for the various taxes, you deduct the entire $6,000 as salary.

It is important to remember that you, as the employer, are liable for payment to the government of the various taxes withheld from your employees' compensation and you are subject to penalties for nonpayment.

The social security and federal unemployment taxes that you pay as an employer are deductible. However, sons and daughters of a partnership are not employees of the partnership within the meaning of these acts, and therefore, payments made on behalf of the partners are not deductible by the partnership as amounts paid on behalf of persons who are employees of the partnership.

For additional information, see Publication 539, *Employment Taxes*, which is available from the Internal Revenue Service.

Other Taxes

In addition to real property taxes and income taxes, there are other taxes that may be deducted (including personal property tax, sales tax, and gasoline tax) if they are incurred in the ordinary course of your trade or business.

Personal property tax. You may deduct any tax imposed by a state or local government on personal property used in your trade or business. Normally, personal property taxes are ad valorem—that is, based on the value of the property. However, they are also deductible if they are based on weight or any other measure.

Registration fees imposed by a state or local government for the right to use property within the state are deductible.

Sales taxes imposed on sales of property or services at retail and measured by gross sales price or gross receipts may be deductible. Rentals qualify as sales if so treated under local law.

Sales taxes collected and paid over to the state are not deductible if you have not included them in gross receipts. If you have, you may take a deduction for them when you pay them over to the state. Because the various states and local jurisdictions have different requirements for collection of sales taxes, you should contact the taxing authorities in your area for sales tax regulations.

Sales tax imposed on the consumer. If state law imposes the sales tax on the ultimate consumer, that individual may deduct the tax paid in purchasing property used in a trade or business even though the property is a capital item (generally, a depreciable asset). However, if the property is a capital item, the consumer may choose to capitalize the tax rather than deduct it.

Sales tax imposed on the seller or retailer. If state law imposes the sales tax on the seller or retailer and allows the seller or retailer to state it separately or pass it on to the consumer, that consumer may deduct, as a business expense, the sales tax paid in purchasing property used in a trade or business, provided that the property is not a capital item (generally, a depreciable asset) or an inventory item. If the property is a capital item or an inventory item, the consumer (business person) must treat the sales tax as part of the cost of the item.

A compensating use tax may be deductible as a sales tax. This tax generally is imposed on the use, storage, or consumption of an item brought in from another taxing jurisdiction. It is often imposed at the same rate as the general sales tax and is often complementary to a general sales tax that is deductible with respect to sales at retail of similar items in the taxing jurisdiction.

Gasoline and other taxes. Taxes you paid on gasoline, diesel fuel, and other motor fuels that you use in your business usually are included as part of the cost of the fuel itself and are not deducted as a separate item.

Also, you may be entitled to a credit for tax paid on fuels used for certain purposes. See Publication 378, *Fuel Tax Credits*.

Unemployment Compensation and disability benefit fund taxes. As an employer, you may be required to make payments to a state unemployment compensation fund or to a state disability benefit fund. These payments are deductible as taxes.

Corporate franchise taxes are deductible as a business expense. If you are a cash-basis taxpayer, you may deduct the franchise tax in the year paid. If you are an accrual-basis taxpayer, you may take a deduction in the year you become legally liable to pay the tax, regardless of the year on which the tax is based. Thus, if your state imposes a franchise tax for 1985 that is based on your corporate net income for 1984, you may deduct the tax in 1985 because that is the year you became legally liable for the tax.

Excise taxes paid or incurred in carrying on your trade or business also may be deducted.

7. Insurance

You may deduct the cost of insurance for your business or profession as a business expense. You generally may not deduct the cost of life insurance. However, see the discussions under *Life Insurance Policies* and *Group Term Life Insurance for Employees*, later.

When to Deduct

Premiums ordinarily are deductible in the tax year to which they apply. If you make an advance payment of the premium for an insurance policy that covers more than one tax year, you cannot deduct the entire premium in the year you make the payment, even if you are a cash basis taxpayer. You may only deduct the proportionate part of the premium that applies to the tax year. You may deduct the balance in each later tax year to which it applies.

Cash method. If you use the cash method of accounting, and in a later tax year you pay a premium for insurance that covers an earlier tax year, no part of the premium is deductible until the tax year it is paid.

Example. You operate a business and file your returns on a calendar year basis. You bought a fire insurance policy on your building effective October 1, 1985, and paid in advance a premium of $1,200 for 2 years. On your 1985 return, you may deduct only tbe proportionate part of the total premium that applies to the 3 months coverage in 1985. The proportionate part of the premium that applies to 1986 and 1987 may be deducted in those years. Since the total policy premium is $1,200 for 2 years, the yearly rate is $600, and the monthly rate is $50. For the 3–month period in 1985, you may deduct $150; for 1986, you may deduct $800; and for the 9–month period in 1987, you may deduct $450.

you use the cash method of accounting, you did not pay the $1,200 premium until uary 1986, you could not deduct on your re- for 1985 the $150 for that year. However, could deduct $750 (the $150 that applies to 5 plus the $600 that applies to 1986) on r return for 1986.

rual method. The insurance expense de- tion for an accrual method taxpayer may end on when economic performance oc- s. If you have a liability to make premium ments, economic performance generally oc- s as the insurance protection is provided to . See the discussion of the economic per- nance rule under *When Can an Expense Be ducted?* in Chapter 1.

idends received. If you receive dividends n business insurance and in prior years you ducted the insurance premiums, the return of art of the premiums as a dividend is income. wever, see in Chapter 1, *Recovery of ount deducted.*

eductible Premiums

Generally, you may deduct premiums paid on siness insurance policies. You may deduct costs of the following kinds of insurance miums that are related to your business:

) Fire, theft, flood, or other casualty insurance.

) Merchandise and inventory insurance.

) Credit insurance to cover losses from unpaid debts. Report the proceeds from this insurance as ordinary income.

) Employees' group hospitalization and medical plans.

) Employers' liability insurance.

) Malpractice insurance that covers a professional's personal liability for negligence resulting in injury or damage to patients or clients.

) Public liability insurance that covers your liability for bodily injuries suffered by persons who are not your employees and for property damage to others.

) Worker's compensation insurance set by state law that covers any claims for bodily injuries or job related diseases suffered by employees in your business, regardless of fault. A partnership may not deduct premiums paid for worker's compensation on behalf of partners as amounts paid on behalf of employees. Partners are not considered employees of the partnership.

) Contributions to a state unemployment insurance fund. You may deduct these contributions as taxes if they are considered to be taxes under state law.

0) Use and occupancy and business interruption insurance. If this insurance pays you for lost profits caused by a business shutdown because of fire or other cause, report the proceeds as ordinary income.

1) Overhead insurance. This insurance pays you for business overhead expenses you have during long periods of disability caused by your injury or sickness. Report a repayment as ordinary business income.

2) Employee performance bonds, such as fidelity, indemnity, performance, and other bonds that insure faithful performance by your employees. Amounts repaid under employee performance bonds should be offset against any theft, embezzlement, or other related loss.

3) Bonds you are required to provide either by law or contract.

4) Car and other vehicle insurance. This insurance covers liability, damages, and other losses from accidents involving vehicles used in your business. If you operate a vehicle partly for personal use, you may deduct only the part of your insurance premiums that apply to the business use of the vehicle. If you use the standard mileage rate to figure your car expenses, you may not deduct those premiums.

Nondeductible Premiums

You may incur expenses for insurance policies that cannot be deducted. The situations described below are specific examples of nondeductible premiums, but they are not the only situations when premiums cannot be deducted.

Manufacturers, processors, and others who include a part of their business insurance premiums in cost of goods sold cannot deduct that part again as a business expense.

Self-insurance reserve funds. Do not deduct amounts periodically credited to a reserve you set up for self-insurance that is equal to the estimated premiums you would have paid an insurance company for business insurance. This applies even if you cannot get business insurance coverage for certain business risks. Your actual losses, however, are deductible.

Loss of earnings. You may not deduct premiums paid on a policy that pays for your lost earnings due to sickness or disability. The proceeds from the payback are not income. However, see the earlier discussion on overhead insurance under *Deductible Premiums.*

Life Insurance Policies

Premiums on a life insurance policy covering yourself or an employee or any person financially interested in your business are not deductible if you are directly or indirectly a beneficiary of the policy. The following discussions illustrate some instances in which expenses for life insurance associated with your trade or business may or may not be deducted as a business expense.

Security for loan. If you take out a policy on your life or on the life of another person financially interested in your business to get or protect a business loan, you cannot deduct the premiums as business expenses. Nor can you deduct the premiums as interest on business loans or expenses of financing loans. In the event of death, the proceeds of the policy are not taxed as income, even if they are used to liquidate the debt.

Keyperson insurance. Premiums you pay or incur on a policy covering any officer or employee, or any person financially interested in your business, are deductible only if:

1) The payments are an ordinary and necessary business expense in the nature of additional compensation,
2) The total amount of all compensation, including insurance premiums, paid to that person is reasonable, and
3) The policy is not beneficial to you either directly or indirectly.

Keyperson insurance premiums are wages subject to ***withholding***, unless the policy is a group-term policy, discussed later.

Increased efficiency of keyperson. If you insure the life of an officer or employee and you are not directly or indirectly a beneficiary under the policy, you will not lose your premium deduction because you may benefit from the increased efficiency of the officer or employee insured.

Split-dollar life insurance plan. You may not deduct your share of premiums paid on a policy on the life of an employee under a so-called "split-dollar" plan. With this kind of plan you and your employee buy an insurance policy in which there is a large cash surrender value.

You pay the part of each premium equal to the increase in the cash surrender value of the policy, and your employee pays any balance. You are entitled to receive out of the proceeds of the policy an amount generally equal to the cash surrender value. The remainder goes to your employee's beneficiaries. The employee must include in gross income the value of the insurance protection that is more than the premiums paid by the employee.

Beneficiary by assignment. If you are a direct or indirect beneficiary of a life insurance policy covering your employees, you cannot deduct the premiums you pay. You are considered a beneficiary of employees' insurance policies if a contract requires the employees to assign the policies to you and grants you the right to terminate the policies and receive the cash values.

Example. Corporation M entered into an insurance contract for its employees. Under the contract, policies are issued to the employees and all premiums are paid by the corporation. The contract requires the employees and their beneficiaries to assign the policies to the corporation. Thus the corporation can carry out the plan of providing insurance for its employees and the employees are prevented from borrowing on the cash surrender or loan values of the policies.

The assignment gives the corporation the right to receive all payments from the insurance company and the right to terminate the policies and receive the cash surrender values without the consent of the employees and their beneficiaries. In the event of the death or disability of an employee, the assignment provides that the corporation is to receive from the insurance company and pay to the employee or beneficiary the insurance proceeds. Corporation M is a beneficiary by assignment and an indirect beneficiary of the policies and may not deduct the premiums paid.

Insurance on a partner. You are a principal partner in a partnership and purchase life insurance on your life, naming your copartners as beneficiaries. Your purpose in doing this is to retain your copartners' investment in the partnership. You are a direct beneficiary and your premiums are not deductible.

Group Term Life Insurance for Employees

Group term life insurance premiums paid or incurred by you on policies covering the lives of your officers and employees who designate their own beneficiaries are deductible if you retain no incidents of ownership, and are not directly or indirectly the beneficiary under the contract. This is true for both permanent and nonpermanent group term life insurance.

Cost may be taxable to employee. An employee, unless disabled, may have to include in income the cost of group term life insurance coverage on his or her life that is more than the cost of $50,000 (discussed later) of this insurance plus any amount paid by the employee toward its purchase. A key employee, however, may have to include in income the cost of the first $50,000 of this insurance. See *Discriminatory group term life insurance plans,* later.

If the insurance includes ***permanent benefits,*** the cost of the permanent benefits minus the amount paid by the employee for the permanent benefits is included in the employee's income. Permanent benefits are economic values extending beyond one policy year, such as paid-up insurance or cash surrender value, that are provided under a life insurance policy.

The cost of group term life insurance on the life of an employee's spouse or children that is paid by the employer is not included in the employee's income if the cost is incidental. The cost is considered incidental if the amount of the insurance payable on the death of a spouse or child is not more than $2,000.

For further information concerning inclusion in the employee's income, see Publication 525, *Taxable and Nontaxable Income.*

Group term life insurance is life insurance that:

1) Provides a general benefit that is excludable from gross income,
2) Is provided to a group of employees,
3) Is provided under a policy carried by the employer, and
4) Provides an amount of insurance to each employee based on a formula that prevents individual selection.

Life insurance that includes permanent benefits is not group term life insurance unless the following conditions are met:

1) The policy or the employer must specify in writing what part of the death benefit provided for each employee is group term life insurance, and
2) The death benefit that is specified as the group term life insurance benefit for any policy year may not be less than the difference between the total death benefit provided by the policy and the employee's deemed death benefit at the end of the policy year.

Death benefits in travel insurance or accident and health policies that do not provide general death benefits are not included within the meaning of group term life insurance.

Groups. Generally, life insurance can qualify as group term life insurance only if you provide it to at least ten full-time employees at some time during the calendar year. However, this does not apply if you meet the following conditions:

1) You provide the insurance to all of your full-time employees or, if evidence of insurability affects eligibility, to all full-time employees who provide satisfactory evidence of insurability to the insurer,
2) You figure the insurance coverage based on a uniform percentage of pay or based on the insurer's coverage brackets, and
3) Evidence of insurability is limited to a medical questionnaire completed by the employee that does not require a physical exam.

You do not have to provide insurance to any of the following:

1) Employees 65 or older,
2) Part-time employees working 20 hours or less a week or 5 months or less in any calendar year, and
3) Employees who have not been employed for the waiting period. The waiting period specified in the policy cannot be more than 6 months.

You may count your employees who do not choose to receive the insurance, unless the employee is required to contribute to the cost of benefits other than the group term life insurance. For example, if an employee could receive group term life insurance by contributing to the cost, that employee is counted in determining whether the group term life insurance is provided to ten or more employees, even if that employee chooses not to receive the insurance. However, if an employee must contribute to the cost of permanent benefits to get group term life insurance, that employee is not counted in determining whether the group term life insurance is provided to ten or more employees, unless the group term life insurance is actually provided to that employee.

Employee. For tax years beginning after 1983, an employee includes a former employee. See *Effective dates,* later.

Independent contractor. A person who formerly worked as an employee and who currently works for the same employer as an independent contractor is considered an employee only for insurance provided because of the person's past work as an employee.

Full-time life insurance agents who are employees for social security tax purposes are treated as employees for the provisions relating to group term life insurance under a policy carried by an employer.

The $50,000 of insurance, referred to earlier, relates to insurance protection the employee receives during any part of the tax year.

Example. An employee is provided $45,000 of group term life insurance for the first 6 months of a tax year and $70,000 for the remaining 6 months. The cost of $20,000 (the amount in excess of $50,000) of the insurance for the second 6-month period is included in the employee's income. This assumes the employee pays nothing toward the cost and, if the employee is a key employee, as discussed later, that the insurance plan is not discriminatory.

Exceptions. The following three exceptions allow employees to exclude from income the cost of group term life insurance that is more than $50,000.

1) An employee stops working for an employer providing group coverage because he or she has become disabled (unable to engage in any substantial gainful activity because of a physical or mental impairment that can be expected to result in death or to be of a long and indefinite duration). For tax years beginning before 1984, retired employees could also exclude the cost of group coverage that is more than $50,000. Now, retired employees are treated like active employees and may have to include in income the cost of coverage that is more than $50,000. See *Effective dates,* later, for rules relating to the applicability of this change in law.
2) The employer is a direct or indirect beneficiary for the whole period that the insurance is in effect in the tax year (the employer may not deduct the premiums for this insurance).
3) A qualified charitable organization is a direct or indirect beneficiary for the whole period that the insurance is in effect in the tax year. However, the employee may not get a charitable deduction for naming such an organization as a beneficiary under the policy.

Example. AB Company paid the entire cost of $100,000 of group term life insurance on the life of employee Jack White that included no permanent benefits. Jack is not a key employee. The policy was in effect for all of 1985. Jack's tax year began on January 1, 1985. On that date he designated a qualified charity as sole beneficiary of $30,000 of the insurance, and the designation remained so throughout the tax year. Jack's wife, Polly, was beneficiary of the remaining $70,000. The cost of $20,000 of the insurance, the amount in excess of $50,000 for which Polly is the beneficiary, is included in Jack's income.

If an employee (or key employee under nondiscriminatory insurance plans) has more than one employer, each employer, in figuring the amount to include in the employee's income, should not include the cost of $50,000 of insurance. This is true even if another employer also provided group term life insurance for the same employee in the same year. However, in this situation, the employee must figure how much to include in income for the cost of all coverage that is more than $50,000.

The monthly cost of group term life insurance is determined by multiplying the number of thousands of dollars of insurance coverage provided to the nearest 10th by the appropriate cost per thousand per month. If group term life insurance is provided for a period of coverage of less than one month, the monthly cost is prorated over that period. The monthly cost of each $1,000 of group term life insurance protection is as follows:

Age	Cost
Under 30	8 cents
30 through 34	9 cents
35 through 39	11 cents
40 through 44	17 cents
45 through 49	29 cents
50 through 54	48 cents
55 through 59	75 cents
60 and over	$1.1

The examples below illustrate the method for figuring the amount included in an employee's income (or key employee's income, if the insurance plan is not discriminatory) for group term life insurance in excess of $50,000.

Example. A 42-year-old employee is provided with $200,000 of group term life insurance protection in 1985. The coverage includes no permanent benefits. The amount to include in the employee's 1985 income is figured as follows.

Amount in excess of $50,000 ($200,000 less $50,000) or $150,000 expressed in thousands	15
Cost in 1985 of protection per $1,000 for one month for individual age 42	.1
Cost of excess insurance for one month	$ 25.5
Number of full months coverage	1
Amount included in employee's income in 1985	$306.0

If an employee pays any part of the cost of providing group term life insurance, the entire contribution of the employee reduces, dollar for dollar, the amount that would otherwise be included in the employee's income because coverage is more than $50,000. However, no reduction is permitted for the current year for an employee's contribution for future year coverage (for example, a prepayment for coverage after retirement) or for the amounts paid toward the purchase of group term life insurance subject to one of the exceptions discussed earlier.

Example. Assume the same facts as in the above example, except that the employee makes a contribution in 1985 of $1 for each $1,000 of coverage.

Cost of excess coverage (from above example)	$306.00
Total premium paid by employee ($1.00 × 200)	200.00
Amount included in employee's income in 1985	$106.00

The cost of permanent benefits included in group term life insurance reduced by any amount the employee pays for permanent benefits is included in the employee's income. The cost of the permanent benefits is figured using a formula and may differ from the cost stated in the policy. Dividends under a group term life insurance policy that includes permanent benefits also may be included in the employee's income.

Example. In 1985 you provide employee K with $70,000 of group term life insurance. K, who is 47 years old, chooses to receive a per-

anent benefit under the policy. K pays $2 for ach $1,000 of group term life insurance. In addition K pays half of the $300 annual premium ated in the policy for the permanent benefit. he cost of the premium allocated to the permanent benefit is $350. You include $200 in K's ncome in 1985 because of the insurance you rovide, figured as follows:

Cost of permanent benefits	$350.00	
Minus: the amount paid by employee K for permanent benefits (½ of $300)	150.00	$200
Cost of group term life insurance in excess of $50,000 (20 × .29 × 12 months)	$ 69.60	
Minus: the amount paid by employee K for group term life insurance (70 × $2)	140.00	
Difference (not less than –0–)		–0–
Amount included in K's income in 1985		$200

Discriminatory group term life insurance plans. For tax years beginning after 1983, a key employee cannot exclude from income the employer-provided cost of the first $50,000 of group term life insurance on his or her life if the plan discriminates in favor of key employees. If the plan is nondiscriminatory, key employees are treated like other employees of the employer, and may exclude from income the cost of up to $50,000 of this insurance. A key employee includes a former key employee who is retired or is disabled.

Key employees receiving benefits under a discriminatory plan must include in income the actual cost of their insurance benefits rather than figuring their cost based on the five-year interval tables, listed earlier. See *Effective dates*, later, for rules discussing the applicability of this change in law.

A discriminatory group term life insurance plan is any plan of an employer providing group term life insurance that discriminates in favor of key employees as to: (1) eligibility to participate, or (2) the type and amount of life insurance benefits provided under the plan.

Eligibility to participate. A plan generally does not discriminate in favor of key employees if:

1) The plan benefits at least 70 percent of all employees,
2) At least 85 percent of all participating employees are not key employees,
3) The plan benefits employees who qualify under a classification set up by the employer and found by the Secretary of the Treasury not to discriminate in favor of key employees, or
4) The eligibility rule is met for a plan that is part of a cafeteria plan (section 125 of the Internal Revenue Code).

In applying these tests, employees of certain related employers are generally treated as if employed by a single employer. Related employers are controlled groups of corporations, commonly controlled trades or businesses, and affiliated service groups.

Some employees, however, are excluded from consideration in applying the eligibility-to-participate requirement. These employees:

1) Have not completed 3 years of service with the employer,
2) Are part-time or seasonal employees,
3) Are nonresident aliens who receive no U.S. source income from an employer, and
4) Are not included in the plan, but are included in a collective bargaining agreement, if the benefits provided under the plan were the subject of good faith bargaining between the employer and employee representatives.

Type and amount of life insurance benefits. A group term life insurance plan may meet the eligibility-to-participate requirements, yet still be a discriminatory plan if it discriminates in terms of the type and amount of life insurance benefits. The benefits available to participating key employees must also be available to all other participating employees. However, under a special rule, group term life insurance benefits will not be considered to discriminate merely because the amount of life insurance provided employees bears a uniform relationship to employees' pay.

Key employees. A key employee is any participant in a group term life insurance plan who, at any time during the plan year or any of the 4 preceding plan years, is:

1) An officer of the employer,
2) One of 10 employees owning (or considered to own, under the related party rules, later) the largest interests in the employer,
3) A 5% owner of the employer, or
4) A 1% owner in the employer having annual pay from the employer of more than $150,000. However, employees having a 1% ownership and pay in excess of $150,000 are not key employees if they are not group-term-insurance participants by reason of being excluded under the eligibility-to-participate requirement, discussed earlier.

Related parties. A party that is considered related to an employee includes members of that individual's immediate family (including husband or wife, children, grandchildren, and parents). These rules also apply to certain relationships between individuals, corporations, partnerships, estates, and trusts. An employee is considered to own an interest owned by a related party and the related party is considered to own the interest of that related employee.

Effective dates. The rules that may require retired employees, or key employees under a discriminatory plan, to include in income the cost of group term life insurance are effective for tax years beginning after 1983.

However, the rules do not apply to any group term life insurance plan in existence on January 1, 1984 (or to comparable successor plans), with respect to an individual who retired under the plan, if that individual had reached age 55 by January 1, 1984, and was either employed by the employer during 1983, or retired from employment with that employer by January 1, 1984. Existing plans must meet the nondiscrimination rules by January 1, 1987, however, for purposes of these rules, coverage for employees retiring before 1987, is not counted.

Withholding. The cost of group term life insurance on the life of the employee that is income to the employee is not subject to income tax withholding.

Form W–2. Employers must report on Form W–2 the cost that is includible in the employee's income. For information on Form W–2, see Circular E, *Employer's Tax Guide*.

8. Costs You Can Choose To Deduct or To Capitalize

There are certain costs that you can choose either to deduct or to capitalize. The choice you make depends on when it is best for you to recover your costs.

If you deduct a cost as an expense, you in effect "recover" it in full—subtract it from income—through the deduction.

If you capitalize a cost, you may be able to recover it through a section 179 deduction or periodic deductions for depreciation, amortization, or depletion. (See Publication 534, *Depreciation*, for information on the section 179 deduction and depreciation, Chapter 9 for information on amortization, and Chapter 10 for information on depletion.) Or you may recover it when you sell the asset you bought and figure your gain or loss on the sale. In addition, you can take the investment credit on many costs that you capitalize. See Publication 572, *Investment Credit*.

The costs that you can choose to deduct or to capitalize include:

- Carrying charges that you must pay to own or develop property,
- Research and experimental costs,
- "Intangible" drilling and development costs for oil, gas, and geothermal wells,
- Exploration costs for new mineral deposits,
- Mine development costs for a new mineral deposit,
- The cost of increasing the circulation of a newspaper or other periodical, and
- The cost of making public transportation vehicles, buildings, and other facilities more accessible.

The decision to capitalize or to deduct belongs to the business entity—the sole proprietor, partnership, corporation, estate, or trust. Individual partners, shareholders, and beneficiaries do not make the choice themselves (except, as discussed below, for exploration expenses for a new mineral deposit).

Other considerations. For individuals, partners, beneficiaries, and S corporation shareholders, all of the costs listed above except carrying charges are items of tax preference if they are deducted and not capitalized.

At the time you decide whether to deduct or capitalize these costs, you do not need to consider the minimum tax treatment of the items because you can later make an annual choice to avoid the tax preference treatment of the cost. You do it by using an optional 10-year writeoff (3-year writeoff for circulation costs) if the alternative minimum tax due to the item is more than the additional income tax you would pay if the item was capitalized and written off over 10 years (3 years for circulation costs).

For more information on the optional writeoff, see Publication 909, *Alternative Minimum Tax*.

Carrying charges. Carrying charges are the taxes, interest, and other fees that you pay with respect to your ownership of property. You can choose to capitalize certain carrying charges that otherwise would be deductible. Three separate categories of carrying charges come under this rule:

1) ***Unimproved and unproductive real property.*** You can choose to capitalize property taxes, mortgage interest, and other carrying charges on real property you own, as long as the property remains unimproved and unproductive.

   Example. You own a vacant lot and pay annual property taxes and interest on the mortgage you took out to buy the lot. The land was unproductive for the first 2 years that you owned it. However, in the third year, you leased the land for use as a parking lot. For each of the first 2 years you can choose to capitalize the taxes and interest you paid. But for the third year, you may not capitalize them, because the land is no longer unproductive.

2) ***Developing or improving real property.*** You can choose to capitalize certain carrying

charges you have during the time you construct improvements on or develop real property. Only carrying charges you have up to the time the construction work is finished can be capitalized. The interest you can choose to capitalize is interest on loans used to finance the development or construction work. You can choose to capitalize taxes on the wages of your employees doing the construction work. This includes state unemployment tax, federal unemployment (FUTA) tax, and your share of social security (FICA) tax. You can also choose to capitalize sales and use taxes on materials used in the construction work. However, you can only choose to capitalize carrying charges that you could otherwise deduct. Sales and use taxes that are actually imposed on the seller (even though they might be stated on your bill) are not deductible expenses. They must be capitalized as part of the cost of your building materials. See Chapter 6.

Special rule. Whether or not you choose to capitalize your carrying charges for the period of construction under this rule, you may, nevertheless, be required to capitalize certain construction period interest and taxes under another rule. However, you recover the interest and taxes you capitalize under this rule through amortization. See *Construction Period Interest and Taxes* in Chapter 9.

3) ***Personal property.*** You may choose to capitalize interest on a loan to finance the purchase, transportation, or installation of fixed assets such as machinery. You may also choose to capitalize sales and use taxes you are required to pay on the purchase, transportation, storage, or use of the assets, as well as taxes on the wages of your employees who transport or install the assets. These taxes include state unemployment, FUTA, and your share of FICA taxes.

Making the choice. You may make a separate choice to capitalize carrying charges for each project you have and for each type of carrying charge. For unimproved and unproductive real property (category 1), your choice is good for only one year. You must make a new choice each year the property remains unimproved and unproductive. For categories 2 and 3, your choice is good for the entire project. Once you choose to capitalize carrying charges for a particular project, you must continue to capitalize them until you finish the project.

To make the choice to capitalize a carrying charge, simply write out a statement saying which charges you choose to capitalize. Attach the statement to your original tax return for the year the choice is to be effective.

Research and experimental costs. The cost of research and experimentation is generally a capital expenditure. However, you can choose to deduct some of these costs as a current business expense.

This choice applies to costs of research and development in the laboratory or experimental sense. It includes the cost of developing or improving a product, a formula, an invention, a plant process, an experimental or pilot model, or something similar. It also includes the cost of any research or experimental work carried on for you by someone else (such as a research institute, foundation, engineering company, or similar contractor). It does not apply to market research, management surveys, or normal product testing.

The choice you make applies to all the research and development costs you have for a project. You cannot choose to deduct some expenses for a project and capitalize others.

However, if you do not choose to deduct your research and development costs for a project, there is another choice that you can make for at least some of your costs. You can choose to treat certain research and development costs as deferred expenses and amortize them over a period of 60 months or more, beginning with the month that you first receive an economic benefit from the research. See *Research and Experimental Costs* in Chapter 9.

How to make the choice. To choose to currently deduct research and development costs, simply claim them as an expense deduction on your income tax return for the year in which you first have them.

If you want to make this choice after the first year, you must get the permission of the Internal Revenue Service. Your request must be in writing and addressed to the Commissioner of Internal Revenue, Attention: CC:C:C, Washington, DC 20224. The request should give your name and address, the first tax year for which the request is made and a description of the project or projects for which the research or experimental expenditures are to be, or have already have been, paid or incurred. The request should be signed and filed not later than the last day of the first tax year for which the change is requested. A change to deduct the costs currently applies only to costs that you have in the year of change and in following tax years.

Research credit. No matter how you treat your research and experimental costs, you may qualify for a credit on some or all of them. See Publication 906, *Jobs and Research Credits*, for more information.

Drilling and development costs. The costs of developing oil, gas, or geothermal wells are capital expenditures. They can usually be recovered through depreciation or depletion. However, you can choose to deduct certain drilling and development costs as current business deductions if you hold an operating or working interest in a parcel of land and are developing oil, gas, or geothermal wells on it.

You can choose to deduct drilling and development costs only for items that, in themselves, do not have a salvage value. This includes wages, fuel, repairs, hauling, and supplies. To be deductible, a cost must be for drilling or preparing a well for the production of oil, gas, geothermal steam, or geothermal hot water. These costs are known as "intangible" drilling and development costs because they are not directly for the purchase of tangible, depreciable business assets.

The cost to you of any drilling or development work, exclusive of depreciable items, done by contractors under any form of contract is also an intangible drilling and development cost.

If you choose to deduct intangible drilling and development costs, you must take the deduction on your income tax return for the first tax year in which you have eligible expenditures. No formal statement is required.

If you capitalize the drilling and development costs of geothermal wells, you may be able to claim a business energy credit. See Publication 572, for more information.

Nonproductive wells. If you capitalize your intangible drilling and development costs, then an additional option is available to you for intangible drilling and development costs you have for a nonproductive well. You may deduct these costs as an ordinary loss, if you indicate your choice on your tax return for the first year in which a nonproductive well is completed. Once the election is made, it is binding for all later years. However, an election for a geothermal well may be revoked by filing an amended return that does not contain the election.

Exploration costs. If the costs of determining the existence, location, extent, or quality of any mineral deposit lead to the development of a mine, they would normally be capital expenditures. You can recover these costs through depletion as the mineral is removed from the ground. However, you can choose to deduct exploration expenses (except those for oil, gas, and geothermal wells) if you have them before the development stage begins. The costs can be deducted without limit if they are for domestic exploration. However, they are subject to a limit if they are for foreign exploration.

Limit for foreign exploration. If you choose to deduct your exploration costs currently rather than capitalizing them, your exploration costs for foreign exploration are subject to an overall limit of $400,000. This $400,000 limit must be reduced by the total amount of all the deductions you have taken over the years for both foreign and domestic exploration expenses, including the current year's deduction for domestic exploration. In certain cases, you must also reduce the limit by the amount of exploration expenses deducted by an individual or corporation that transferred mineral property to you. In other words, if you have already claimed $400,000 in exploration expense deductions, you cannot deduct any of your foreign exploration expenses.

Partnerships. Each partner, rather than the partnership, chooses whether to capitalize or deduct that partner's share of exploration expenses. The $400,000 limit is applied to each partner, not the partnership.

Choosing to currently deduct exploration costs. If you want to deduct your exploration costs, you must take the deduction on your income tax return or an amended income tax return for the first year for which you desire to deduct exploration costs. Except for costs subject to the $400,000 limit, the choice applies to all the exploration costs you have during the tax year and all following tax years. Your return must adequately describe and identify each property or mine, and clearly state how much is being deducted for each one.

Reduced deduction for corporations. Corporations (other than S corporations) must reduce their deduction for ***exploration*** costs by 20%. The corporation may deduct 80% of the exploration costs it has in 1985. It must capitalize the remaining 20% and recover it over a 5-year period starting with the tax year the exploration costs are paid or incurred. The 20% is treated as if it is recovery property assigned to the 5-year class. See Publication 534 for the percentages used for 5-year property. The 20% the corporation must capitalize cannot be added to its basis in the property for purposes of figuring cost depletion. However, it can be taken into account for purposes of figuring gain or loss on a sale.

The amount the corporation must capitalize is treated as a qualifying investment in 5-year recovery property for purposes of the investment credit. If it disposes of the property, it must recapture the investment credit as it would for 5-year recovery property. For more information, see Publication 572.

Recapture of exploration expenses. Once your mine reaches the producing stage or is disposed of, you must recapture any exploration expenses you deducted for it. If you receive a bonus or royalty income on the mine property, you must recapture by deferring the depletion deduction on the bonus or royalty income until an amount equal to exploration expenses is recovered. If you dispose of the mine before it reaches the producing stage, you

must recapture your deductions by treating all or part of your gain as ordinary income. When the mine reaches the producing stage, the recapture will be by one of the following two methods.

Method 1. Including an amount equal to the adjusted exploration expenses in your gross income, or

Method 2. Not taking a depletion deduction until the exploration expenses are recovered.

If you wish to recapture by method 1, you must clearly indicate your choice on your return for the tax year the mine or property reaches the producing stage. This choice must be made by the due date (including extensions) of your return. If your return does not indicate that you are using method 1, you have made a binding choice of method 2.

Development costs. You may deduct costs paid or incurred during the tax year for developing a mine or any other natural deposit (other than an oil or gas well or geothermal property) if they are paid or incurred after the discovery of ores or minerals in commercially marketable quantities. Or you may choose to treat the expenditures as deferred expenses, deductible on a ratable basis when you sell the units of produced ores or minerals benefited by the expenditures. These expenditures need not be incurred by you directly. You may engage a contractor to incur them on your behalf. Development expenditures do not include depreciable improvements.

The choice to treat the expenditures as deferred development costs applies only to expenditures for the tax year for which they are made. Once made, the choice is binding for that tax year and cannot be revoked for any reason. The choice must be made for each mine or other natural deposit by a clear indication on the return, or by a statement filed with the Internal Revenue Service office at which the return was filed, not later than the time prescribed by law for filing the return, including extensions, for the tax year to which the choice applies.

Reduced deduction for corporations. Corporations (other than S corporations) must reduce their deduction for ***development*** costs by 20%. The treatment discussed under *Reduced deduction for corporations*, earlier for exploration costs also applies to development costs.

Circulation costs. The costs of increasing the circulation of a newspaper, magazine, or other periodical are deductible business expenses. For example, you can deduct the cost of hiring extra employees for a limited time to get new subscribers through telephone calls. These costs are deductible even if they result in an asset, such as a subscriber list, having a useful life of more than one year.

However, a publisher can choose to capitalize the costs (which are chargeable to a capital account) of increasing circulation. If the costs are capitalized, the publisher may be able to recover them over the useful life of the assets that result.

Purchases of land or depreciable property and purchases of any part of the business of another publisher do not come under this rule. These costs ***must*** be capitalized.

Choosing to capitalize. To show you are choosing to capitalize circulation costs, attach a statement to your return for the first tax year the choice applies. The choice is binding for the year it is made and for all later years, unless you get the permission of the Internal Revenue Service to revoke your choice.

Improving access for handicapped and elderly people. The cost of an improvement to a business asset is normally a capital expenditure. However, for tax years beginning after 1983 and before 1986, you can choose to deduct the cost of improvements that make a building, public transportation vehicle, or other facility more accessible to elderly and handicapped people. This rule applies to improving any part of a building, structure, road, walk, parking lot, piece of equipment, bus, railway car, or similar property. You may not deduct any costs that you had in completely renovating or building a new facility or public transportation vehicle, or in normally replacing depreciable property. The most you can deduct as a current expense each year is $35,000.

For your costs to be deductible as a current expense, certain specific standards for improved access for elderly and handicapped people must be met. See Publication 907, *Tax Information for Handicapped and Disabled Individuals*, for these standards.

Partners and partnerships. The $35,000 limit applies to a partnership and also to each partner in the partnership. In figuring this limit, a partner must divide the $35,000 between any costs that were individually incurred and any costs that were received as a distributive share from the partnership. If this division results in the partner not being able to deduct all of the share received from the partnership, the partnership may add back any costs the partner does not deduct to the basis of the improved property.

A partnership must be able to show that any amount added back to basis was not deducted by the partners and that it was the amount that was over a partner's $35,000 limit (as determined by the partner). If the partnership cannot show this, it is presumed that all the partners were able to deduct their distributive shares of the partnership's costs in full.

Choosing to deduct. If you choose to deduct your costs for improving access for elderly and handicapped people, you must claim the deduction on your income tax return (partnership return for partnerships) for the tax year for which your choice applies. You must identify the deduction as a separate item. For your choice to be valid, you must file your return no later than its due date, including extensions. Your choice is irrevocable after the due date of your return. The choice you make must apply to all the qualifying costs you have during the year, up to the $35,000 limit. If you make this choice, you must maintain adequate records to support your deduction.

9. Amortization

You may be able to deduct each year as amortization a part of certain capital expenditures. Amortization lets you recover these expenditures in a way that is like straight line depreciation. Only certain specified expenditures may be amortized for federal income tax purposes.

Since amortization sometimes allows a write off of your costs that are not ordinarily deductible, you may want to elect to recover your eligible costs by taking amortization deductions.

If you want to amortize your expenditures, you must make an election to do so. The election is made by reporting the deduction on Form 4562, *Depreciation and Amortization*, and by attaching a statement to the form. See the discussion under the various types of amortization for more information.

Going Into Business

When you go into business, all the costs you had to get your business started are treated as capital expenditures and are a part of your basis in the business. Any costs that were for particular assets can generally be recovered through depreciation deductions. Other costs generally cannot be recovered until you sell or otherwise go out of business. However, you can elect to amortize certain costs that you have in setting up your business. These costs are deducted in equal amounts over a period of 60 months or more. To be amortizable in this way, costs must qualify in one of the following three areas.

1) Business start-up costs,
2) Organizational costs for a corporation, or
3) Organizational costs for a partnership.

The sections below discuss which costs qualify in each of these three areas.

Business start-up costs. Start-up costs are those that you have in connection with setting up an active trade or business, or for investigation of the possibility of creating or acquiring an active trade or business. To be amortizable, a start-up cost must meet the following tests:

1) It must be deductible if it were paid or incurred to expand an existing trade or business.
2) It must be paid or incurred by you before you actually begin business operations.

Start-up costs include what you pay both for investigating a prospective business and for getting the business started. For example, they may include costs for items such as the following:

A survey of potential markets.

An analysis of available facilities, labor, supplies, etc.

Advertisements for the opening of the business.

Salaries and wages for employees who are being trained, and for their instructors.

Travel and other necessary costs for securing prospective distributors, suppliers, or customers.

Salaries and fees for executives and consultants, or for other professional services.

Start-up costs also include any amounts paid or incurred in an activity engaged in for profit and for the production of income in anticipation of the activity becoming an active trade or business. To be amortizable the costs must be paid or incurred before the day on which the active trade or business begins.

Start-up costs do not include deductible interest, taxes, and research and experimental costs. See the discussion of *Research and Experimental Costs*, later. If you completely dispose of a trade or business before the end of the amortization period selected, any deferred start-up costs attributable to the trade or business that have not been deducted may be deducted to the extent they qualify as a loss from a trade or business.

Start-up costs do not include any organizational costs for a corporation or a partnership. These costs are discussed next.

Organizational costs for a corporation. Corporate organizational costs are those that are directly connected with the creation of the corporation. They include the cost of temporary directors, organizational meetings, state incorporation fees, and accounting services related to setting up the organization. They also include the cost of legal services, such as drafting the charter, bylaws, terms of the original stock certificates, and minutes of organizational meetings.

However, costs for issuing and selling stock or securities, such as commissions, professional fees, and printing costs are not organizational costs and may not be amortized. Costs

connected with the transfer of assets to the corporation also cannot be amortized.

To qualify for amortization, an organizational cost must meet all three of the following tests:

1) It must be incident to the creation of the corporation. The cost must be incurred before the end of the first tax year in which the corporation is in business. A corporation using the cash method may amortize organizational expenses incurred within the first tax year even if it does not pay them in that year.
2) It must be a cost that is chargeable to a capital account.
3) It must be one that could be amortized over the life of the corporation, if the corporation had a fixed life.

Organizational costs for a partnership. Partnership organizational costs are those that are incident to the creation of the partnership. To be amortizable, an organizational cost must be one that is chargeable to a capital account; and it must be one that could be amortized over the life of the partnership, if the partnership had a fixed life.

Partnership organizational costs do not include syndication fees. That is, they do not include costs connected with the issuing and marketing of interests in the partnership, such as commissions, professional fees, and printing costs.

How to amortize. The costs that qualify in these three areas are deducted in equal amounts over a period of not less than 60 months. You can elect a different period for start-up and for organizational expenses, as long as each is 60 months or more. Once you elect an amortization period, you cannot change it.

To figure your deductions, divide the total of your start-up or organizational costs by the number of months in the amortization period. The result is the amount that can be deducted each month.

The amortization period starts with the month you begin business operations. (You can amortize only if you actually go into business.) For the amortization of organizational costs, a partnership or corporation is considered to begin business operations when it starts the activities for which it is orgahized. This can happen either before or after the corporate charter is granted or a partnership agreement is signed. A partnership or corporation will be considered as having begun business if its activities have reached the point where the nature of its business operations can be established. For example, if it acquires the assets it needs to operate its business, this may constitute the beginning of business activities.

Making the election. If you want to amortize your costs, you must attach Form 4562 to your income tax return. If you elect to amortize both start-up and organizational costs, in addition to furnishing all of the information required in Part II of Form 4562, you must also attach a separate statement to your return for each type of cost. Each statement should:

1) Show the total amount of the start-up or organizational costs you will amortize,
2) Describe what each is for,
3) Give the date each was incurred,
4) State the month your business began operations (or the month you acquired the business), and
5) Specify the number of months in your amortization period (not less than 60).

Each statement must be attached to your return for the tax year in which the amortization period starts, the first tax year that you are in business. Both the statement and the return must be filed by the due date for the return (including any extensions of time).

Partnerships and corporations. If your business is organized as a partnership or corporation, only the partnership or corporation can elect to amortize its start-up or organizational costs. A partner or shareholder cannot make this election.

If you incur costs in setting up your partnership or corporation, you cannot amortize them. If the partnership or corporation does not reimburse you for these costs, it cannot amortize them. These costs then become part of the basis of your interest in the business. You can recover them only when you sell your interest in the partnership or corporation.

However, you, as an individual, can elect to amortize the costs you incur to investigate an interest in an existing partnership. These costs qualify as business start-up costs if you succeed in acquiring the interest.

Reforestation Expenditures

You may elect to amortize a limited amount each year of your reforestation expenditures for qualified timber property.

Reforestation expenditures are the direct costs incurred in planting or seeding for forestation or reforestation purposes. Qualifying expenditures include amounts spent for site preparation, seeds or seedlings, labor, tools, and depreciation on equipment used in planting or seeding. Site preparation includes girdling, herbicide application, baiting of rodents, and brush removal. The qualified costs include only those that must be capitalized and included in the adjusted basis of the property. Deductible costs do not quality.

If the government reimburses you for your expenses under a cost-sharing program, these expenses cannot be amortized unless you include the reimbursement in income.

Qualified timber property must be property located in the United States that is held by you for the growing and cutting of timber that will either be used by you in, or sold for use in, the commercial production of timber products. The property may be a woodlot or other site but it must consist of at least one acre that is planted with tree seedlings in a manner normally used in forestation or reforestation. You do not have to own the property, therefore, you may elect to amortize qualifying reforestation expenditures that you incur on qualified leased property. Qualified timber property does not include property on which you have planted shelter belts or ornamental trees, such as Christmas trees.

Yearly limit. The maximum amount of qualified expenditures you may elect to amortize is $10,000 of the costs incurred during each tax year. The yearly limit is $5,000 for a married individual filing a separate return. There is no carryover or carryback of qualifying expenditures in excess of the yearly limit. The yearly limit applies to expenditures paid or incurred during a tax year on all of your qualifying timber property. If you incur more than $10,000 in expenditures for more than one piece of timber property, you may allocate the yearly limit among the properties. For example, if you incur $10,000 of qualifying expenditures on each of four qualified timber properties in 1985, you may elect to amortize $2,500 of the amount spent on each property, or you may elect to amortize $10,000 spent on any one property.

Partnerships and S corporations. Similar rules apply to both partnerships and S corporations.

A partnership or S corporation makes the election to amortize its qualified expenditures. The yearly limit of expenditures that can be amortized is applied to a partnership and an S corporation as well as to each partner and shareholder. The yearly limit for a partnership and an S corporation is $10,000. The expenditures of a partnership (or S corporation) are allocated among the partners (or shareholders).

A partner or shareholder is again subject to a yearly limit of $10,000 ($5,000, if married and filing a separate return) in the aggregate. For example, if a married individual is a partner in two or more partnerships that elect to amortize qualified expenditures, the individual's total share of partnership amortizable basis may not be more than $10,000 on a joint return, or, $5,000 on a separate return. ***Amortizable basis*** is the part of the basis of qualified property that is attributable to reforestation expenditures.

Estates may elect to amortize up to $10,000 of qualified reforestation expenditures incurred in each tax year. Any amortizable basis acquired by an estate is apportioned between the estate and the income beneficiary on the basis of the income of the estate allocable to each. The amount of amortizable basis apportioned from an estate to a beneficiary is taken into account in determining the beneficiary's yearly limit.

Life tenant and remainderman. If property is held by one person for life with the remainder to another person, the life tenant is entitled to the full amortization up to the $10,000 limit for reforestation expenditures made by the life tenant. The remainder interest is ignored for purposes of amortization.

Amortization period. Each year's maximum of $10,000 can be amortized over a period of 84 months. The 84-month period starts on the first day of the seventh month of the tax year in which the cost is incurred. Therefore, you may only claim amortization deductions for 6 months for the first and eighth tax years of the period over which the reforestation expenditure will be amortized.

Example. John Jones incurred qualified reforestation expenditures of $8,400 in 1985. He first figures his monthly deduction by dividing $8,400 by 84 to arrive at $100. Since 1985 is the first year of the 84-month period, he may only deduct $600 ($100 a month for 6 months).

Recapture. If property on which amortization for reforestation expenditures was taken is sold or otherwise disposed of, within 10 years of the year in which the amortizable basis (expenditures incurred) was created, some or all of any gain may have to be reported as ordinary income. See Publication 544, *Sales and Other Dispositions of Assets*, for information on recapture.

Investment credit. Reforestation expenses qualify for investment credit, whether or not they are amortized, see Publication 572, *Investment Credit.*

Election. To make this election, you attach to your income tax return Form 4562 and enter the deduction on Part II of that form. You must also attach a statement to Form 4562 that describes the expenditure and provides the dates they were incurred. The statement should also show the type of timber being grown and the purpose for which it is being grown. A separate statement must be included for each property for which reforestation expenditures are being amortized. The election may only be made on a timely return (including extensions of time to file) for the tax year in which the expenditures were made.

Revocation. You must get consent to revoke an election to amortize reforestation expenses. An application to revoke should set forth your name, address, the years for which the election was in effect, and your reason for revoking the

election. The application must be signed and filed at least 90 days before the time prescribed (without regard to extensions) for filing your income tax return for the first tax year for which the election is to terminate. The application should be sent to the Commissioner of Internal Revenue, Washington DC 20224.

Pollution Control Facilities

In general, you may elect to amortize the cost of a certified pollution control facility over a period of 60 months. The amortization deduction is available based on the amortizable basis of any certified pollution control facility that is used in connection with a plant (or other property) that was in operation before 1976.

Certified pollution control facility. A certified pollution control facility is a new identifiable treatment facility used to abate or control water or atmospheric pollution or contamination by removing, changing, disposing, storing, or preventing the creation of or emission of pollutants, contaminants, wastes, or heat. It must be appropriately certified by state and federal certifying authorites.

The facility must not significantly increase the output or capacity, extend the useful life, or reduce the total operating cost of the plant or other property. It also must not significantly change the nature of the manufacturing or production process or facility.

If it appears that all or a part of the cost of a facility will be recovered from its operation, such as through sales of recovered wastes, the federal certifying authority will certify to that effect, describing the nature of the potential cost recovery. The cost of the facility which may be amortized must be reduced accordingly.

New identifiable treatment facility. A new identifiable treatment facility is tangible depreciable property. A building and its structural components would not be included unless the entire building is exclusively a treatment facility.

The 60–month amortization period begins either with the month that follows the month the facility was completed or acquired, or with the next tax year, whichever you choose. The amortization deduction for any month replaces the regular depreciation deduction that would be allowable for that month for the part of the facility that is eligible for amortization.

Investment credit. If the facility has a useful life of at least 5 years, you may take an investment credit on it, but if the amortized facility also is financed by industrial development bonds, you are limited to a 5% investment credit. See Publication 572.

Amortizable basis. The amortizable basis is the part of the adjusted basis of the facility that may be amortized over the 60–month period. This is usually the amount that you would use when figuring a gain on disposition of the facility.

Reduced amortizable basis for corporations. Corporations that elect amortization for any certified pollution control facility must reduce the amortizable basis of the facility by 20%.

Allocation of basis. You must allocate the property's adjusted basis between the part of the property that qualifies for amortization and the part that does not.

Special rule. If the facility has a useful life of more than 15 years, the amortizable basis must be reduced. The amortizable basis (determined without regard to any reduction due to the useful life of the facility) is multiplied by a fraction, the numerator of which is 15 years, and the denominator of which is the facility's estimated useful life (in years). The result is the amortizable basis as revised to take into account the facility's useful life.

The amortizable basis may not be increased for any additions or improvements that are made after the amortization period has started.

For information on the reduction of the amortizable basis, see section 169 of the Internal Revenue Code and the regulations thereunder.

Electing amortization. If you elect to amortize the amortizable basis of a pollution control facility, the election is made by attaching Form 4562 to your timely filed income tax return, including extensions, for the first tax year in which the 60–month amortization period begins. Your deduction is entered in Part II of Form 4562. You must also attach a statement to Form 4562 that gives information identifying the facility, when it was completed, its useful life and cost, the date when the amortization period is to begin, the date the plant or property in connection with which the facility is used was placed in service, and an estimate of profits to be realized, for example, from the sale of recovered products.

Individuals, estates, and trusts that elect amortization must attach Form 6251, *Alternative Minimum Tax Computation*, to their return even if they are not liable for the tax.

Termination of amortization deduction. The amortization deduction may be terminated at any time during the amortization period. The amortization is terminated by filing a statement with your District Director or with the Director of the Internal Revenue Service Center where your tax return is filed for the tax year in which the first month falls for which you are choosing to terminate your amortizaton of the facility. The statement must clearly identify the certified pollution control facility and specify the month for which you choose to discontinue amortization deductions. If a certification has been issued, attach to the statement a copy of the certification by the federal certifying authority.

Following this termination, the property may be depreciated in the first month in which the amortization deduction does not apply. After an amortization deduction has been terminated, you cannot take any additional amortization deduction for that pollution control facility.

Construction Period Interest and Taxes

Individuals, personal holding companies, and corporations (including S corporations) are not allowed to deduct real property construction period interest or taxes (except as noted later under *Amortization deduction)* that are paid or accrued in the tax year on property that is expected to be used for a trade or business or in an activity conducted for profit. Instead, these amounts must be capitalized and may be amortized. These provisions do not apply to low-income housing or property that is not, or cannot reasonably expect to be, held in a trade or business, or in an activity conducted for profit.

For construction period interest and taxes paid in tax years beginning after December 31, 1984, all corporations are required to capitalize residential real property construction period interest and taxes for construction begun after March 15, 1984.

Construction period interest and taxes means:

1) All interest you pay or accrue during the construction period on a debt to acquire, build, or carry real property that would otherwise be deductible, and
2) All real property taxes you pay or accrue during the construction period that would otherwise be deductible.

The ***construction period*** begins on the date on which construction of the building or other improvements begins, and ends on the date on which the item of property is ready to be placed in service or is ready to be held for sale.

Amortization deduction. A fixed percentage of the interest and taxes may be deducted in the tax year paid or accrued and in each following amortization year as shown in the table below.

If the amount is paid or accrued in a tax year starting in—		
Nonresidential property	Residential property	Percentage for each year
—	1980	16 ⅔
1979	1981	14 ⅔
1980	1982	12 ½
1981	1983	11 ⅓
after 1981	after 1983	10

Amortization year means the tax year in which the amount is paid or accrued, and each tax year thereafter, starting with the later of (1) the tax year after the tax year in which the amount is paid or accrued, or (2) the tax year in which the real property is ready to be placed in service or is to be held for sale, until the full amount has been allowed as a deduction (or until the property is sold or exchanged).

Reporting amortization. You report and deduct your amortization deduction on Form 4562 attached to your income tax return for the first tax year in which the amortization period begins. The deduction is entered in Part II of Form 4562.

Research and Experimental Costs

Research and experimental costs may be amortized or they may be deducted as current business costs. You have the choice to deduct the costs currently or to treat them as deferred costs and amortize them in equal amounts over a period of not less than 60 months. See Chapter 8 for a discussion of the choice to deduct the costs.

Individuals have a third choice. They may elect to deduct research and experimental costs ratably over a 10–year period beginning with the tax year in which the costs are incurred. This election is made by reporting the yearly deduction on Form 4562. See *Optional write-off* in Publication 909, *Alternative Minimum Tax.*

The amortization deduction is an election that applies to those costs that are: (1) paid or incurred by you in connection with your trade or business, (2) not being currently deducted, and (3) chargeable to a capital account. If the costs are chargeable to a capital account and they have no determinable useful life, you may elect the 60–month amortization. However, if they are chargeable to a capital account and have a determinable useful life, you must capitalize the costs and depreciate them over their useful life. An example is your costs for investigating and acquiring a license. These costs must be capitalized and depreciated over the determinable life of the license.

Your costs that you elect to amortize are accumulated starting with the year you make the election to amortize. You should select an amortization period at the time you make the election. If you have two or more separate projects, you may select a different amortization period for each project. Your amortization period begins with the month in which you first realize benefits from the costs.

You may not only amortize costs paid or incurred by you, but you can also amortize costs paid or incurred on your behalf by another person or organization. However, costs incurred on your behalf do not include those costs for

acquiring or improving land or depreciable property used in relation to the research or experimentation if you acquire the rights of ownership.

Research or experimental costs are those costs incurred in relation to your trade or business that are research and development costs in the experimental or laboratory sense. Such costs include costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned. Costs incurred in the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions are not qualifying costs.

Example. You are a calendar year taxpayer who, in 1981, chose to defer research and experimental costs you had in connection with a particular project. You informed the Internal Revenue Service that you would defer your expenses for the project and amortize them over 60 months. In 1983 these deferred expenses totaled $60,000. At that time the project had resulted in a process that you tried to patent.

On July 1, 1983, you began marketing products produced using the process. This was when you first realized a benefit from the research. Therefore, you began to amortize the $60,000 in deferred expenses beginning July 1, 1983. Based on the 60-month period you chose, you deducted $6,000 in 1983 and $12,000 in 1984.

On July 1, 1985, you obtained a patent on your process. Since the patent has a useful life, the balance of the deferred expenses as of July 1, 1985, must be capitalized as the cost of the patent. On your return for 1985, you will claim an amortization deduction for January 1, 1985, through June 30, 1985, based on the 60-month period. For the period July 1, 1985, through December 31, 1985, you will also claim an amortization deduction for the cost of the patent based on its useful life.

Election. If you elect to amortize your costs, your deduction begins with the month in which you first realize benefits from the costs. You will be deemed to be realizing benefits from the costs in the month in which you first put the process, formula, invention, or similar property relating to the costs to an income-producing use.

You make your election to amortize research and experimental costs by attaching a signed statement to your income tax return for the first tax year in which you have expenses that will be deferred.

The statement should:

1) Give your name and address.
2) Note the tax year to which the choice first applies.
3) State whether your choice applies to all the research and experimental costs you have, or only to the costs of a particular project. It should also include enough information to identify the project or projects for which you are making the choice.
4) Give the amount of deferred expenses you have during the tax year.
5) Indicate the number of months (not less than 60) you have selected for amortization. You can select a different amortization period for each project.
6) State that you will keep the costs you wish to treat as deferred expenses separate in your books and records.

Your amortization deduction is entered on Part II of Form 4562 that is attached to your tax return.

Individuals, estates, and trusts that elect amortization must attach Form 6251 to their return even if they are not liable for the alternative minimum tax.

Changing the election. The election applies for the tax year in which the election is made and all subsequent tax years, unless you receive permission to change to a different period or method. An application for change of treatment is made by filing Form 3115, *Application for Change in Accounting Method,* addressed to the Commissioner of Internal Revenue, 1111 Constitution Avenue, N.W., Washington, DC 20224, Attention: CC:C:C. The application should be filed no later than the end of the first tax year in which the different method or period is to be used.

Bond Premium

Bond premium is the amount you pay for bonds that is greater than the face value of the bonds.

You must amortize the premium on tax-exempt bonds, but you may not deduct the amortizable premium in figuring your taxable income.

You may elect to amortize the premium on taxable bonds. If you do not elect to amortize the premium, it will be treated as part of your basis of the bond.

You decrease the basis of the bond by the amortizable bond premium in all cases in which you are required, or elect, to amortize the premium. This will give you the adjusted basis you will use to figure the correct gain or loss on the sale or redemption of the bond.

A ***dealer in bonds*** or anyone who holds them mainly for sale to customers in the ordinary course of a trade or business and who would properly include bonds on hand in inventory at the close of the tax year cannot claim a deduction for amortizable bond premium. Instead the premium is part of the cost of the bonds.

Electing to amortize. You elect to amortize a bond premium by claiming a deduction on Form 4562 attached to your income tax return for the first tax year for which you want the election to apply, and by attaching to Form 4562 a statement showing how you figured your deduction. Your deduction is reported on Part II.

This election is binding for the year you make it and for later tax years. It applies to all similar bonds you own in the year you make the election, and also to those you acquire in later years.

You may change your decision to amortize a bond premium only with the written approval of the Internal Revenue Service.

Example. You are a calendar year taxpayer. On July 2, 1985, you paid $1,120 for a $1,000 taxable bond that will mature on July 2, 1995. You elect to amortize the bond premium using the straight line method. You may deduct $6 for 1985, figured as follows:

Purchase price of bond on July 2, 1985	$1,120
Face value of bond at maturity	1,000
Bond premium	$120

6 (months held in tax year) ÷ 120 (months from acquisition to maturity) × $120 (total bond premium) = $6 (part of bond premium deductible)

Your adjusted basis of the bond is then reduced as follows:

Purchase price of bond at July 2, 1985	$1,120
Less: Amortization deducted in 1985	6
Adjusted basis on December 31, 1985	$1,114

During 1985 you received $15 interest on the bond. This amount is fully taxable and must be included in income on your 1985 return.

Yield method. You may also amortize your bond premium using the yield method. See section 171 of the Internal Revenue Code and the regulations thereunder.

Child-Care Facilities

Any capital expenditure you made after 1971 but before 1982 in acquiring, constructing, reconstructing, or rehabilitating child-care facilities that were mainly for your employees' children were amortizable over a 60-month period if you so elected. To qualify, the property had to be depreciable and located in the United States. Amortization is taken in place of depreciation.

Deducting amortization. You deduct amortization for child-care facility expenditures made before 1982 by attaching Form 4562 to your income tax return (or amended return) for each tax year of the amortization period. Your deduction is entered in Part II of Form 4562. You must also attach a statement to Form 4562 that provides:

1) The date on which the expenditure was made for the item of property,
2) The date on which the item of property was placed in service, and
3) The amount of the expenditure for the item of property.

The election to amortize is binding and irrevocable for each item of property to which it applies.

Ordinary income rule. Gain you realize on the disposition of a facility for which you took the special amortization deduction is treated as ordinary income to the extent of the amortization deductions you took.

Agreement Not to Compete

If an agreement not to compete between you and the seller accompanies the transfer of goodwill in the sale of a business and the agreement assures you of the beneficial enjoyment of the goodwill you acquire, the agreement becomes nonseverable and its cost is considered a capital asset that, like goodwill, cannot be depreciated. However, an agreement not to compete for a fixed number of years that is not, in effect, a sale of goodwill is subject to depreciation based on its estimated useful life. If the latter applies, the deduction is entered in Part I, Section C, *Depreciation of Nonrecovery Property,* of Form 4562.

You must establish from the facts and circumstances in your particular case whether you have purchased goodwill or whether you have entered into an agreement not to compete.

Cost of Acquiring Lease

If you acquire a lease or leasehold for business purposes, you may recover the cost by amortizing it over the term of the lease. The cost includes commissions to obtain a lease or to secure a tenant. Your deduction is entered in Part II of Form 4562.

Commissions or Finders' Fees

Commissions or finders' fees paid to locate money that you can borrow, or to locate borrowers to whom you can lend, are part of the acquisition costs of the loans, and are not deductible as current expenses. They must be amortized over the period for which the money is borrowed. Your deduction is entered in Part II of Form 4562.

Trademarks and Trade Names

You may elect to amortize amounts you spend for the acquisition, protection, expansion, registration, or defense of trademarks and trade names. If you make the election, you may amortize these expenses over a period of not less than 60 months. The 60–month period begins with the first month of the tax year in which you have the expenses. This election does not apply to any part of the purchase price of an existing trademark, trade name, or the cost of acquiring rights to use an existing trademark or trade name. If either is your case, see *Franchises, trademarks, trade names,* discussed later in Chapter 11.

You elect to amortize these amounts by attaching Form 4562 to your timely filed income tax return for the tax year in which you had the expenses. You may make a separate election for each trademark or trade name. Your deduction is entered on Part II of Form 4562. You must also attach a statement to Form 4562 that identifies the character and amount of each expenditure and the number of months (not less than 60) over which you will take the amortization. Your statement must also contain a declaration that you will keep separate entries on your books and records for the trademark and trade name expenditures for which the election has been made, sufficient to permit an identification of the character and amount of each expenditure, and the amortization period selected for each expenditure.

Rehabilitating Historic Structures

After 1981, you may no longer elect to amortize the capital expenditures you incur to rehabilitate a certified historic structure. These expenditures must now be depreciated using the alternate accelerated cost recovery system (straight line ACRS method). You may also be able to take a higher investment credit for your qualified rehabilitation expenditures. This applies to certified historic structures that are used in a trade or business or held for the production of income. See Publication 572 for more information.

Recapture of amortization. If you dispose of the property for which you claimed amortization deductions for the rehabilitation of a certified historic structure, part or all of any gain on the disposition may be recaptured as ordinary income under the rules for depreciation recapture. For more information, see Publication 544.

Tax preference item. Amortization deductions for the rehabilitation of certified historic structures are items of tax preference to the extent the deductions exceed the amount that could be claimed by using the straight line method of depreciation and by using the actual useful life of the property.

Deducting amortization. You claim an amortization deduction by entering the amount of your deduction on Form 4562 attached to your income tax return. Enter the deduction in Part II of Form 4562.

Choosing to discontinue amortization. If you decide you no longer want to continue the amortization deduction, you must include a statement with your income tax return for the tax year in which the first month you discontinue the amortization would fall. For a partnership, the statement is to be attached to the partnership return.

This statement should state what month you want to discontinue amortization. The statement must describe and identify the certified historic structure and the rehabilitation on which you are discontinuing amortization.

Attach a copy of the certification letter to your return. If you do not have final certificaton, include a copy of the first page of the application for certification. A copy of the letter of certification must be submitted with your next return after you receive that letter. If the required certification has not been issued and 30 months or more have passed since these amortization deductions were first claimed, you may be required to consent to extending the period for assessment for any tax year relating to the time for which amortization deductions were claimed. If you have established multiple amortization periods for one structure, a decision to discontinue amortization on one such period ends all amortization periods for that structure.

If you choose to discontinue amortization deductions, the unamortized rehabilitation costs are added to the adjusted basis of the structure as of the first day of the month for which the notice to discontinue amortization deductions is effective. You may then figure deductions for depreciation of the structure on the resulting adjusted basis beginning at that time. Use the estimated remaining useful life of the rehabilitated structure on the date the amortization deductions ends.

Demolition of structures. You may not deduct any amount paid or incurred to demolish any structure, or any loss pertaining to the undepreciated basis of a structure. Instead, you must add these costs to the basis of the land on which the demolished property was located.

Rehabilitation of Low-Income Housing

If you make property improvements to rehabilitate low-income rental housing before 1987, you may elect to depreciate your expenditures under the straight line method using a useful life of 60 months with no salvage value. Rehabilitation expenditures incurred after 1986 will be eligible for the 60–month life if the expenditures were incurred under a binding contract entered into before 1987, or if the rehabilitation was begun before 1987. See *Binding contract,* later.

To be eligible for this 60–month depreciation, your property must be held for occupancy by families and individuals of low or moderate income.

If you make the election, no other type of deduction for depreciation or amortization may be taken with respect to that part of the basis of the property.

Rehabilitation expenditures are amounts chargeable to the capital account for depreciable property with a useful life of at least 5 years. An expenditure is considered paid or incurred on the date it would be considered incurred under the accrual method of accounting, regardless of the accounting method used for other items of income and expense. Thus, even though you are on the cash method of accounting, expenditures will be considered paid on the date that all events that establish your liability for the expenditures have occurred, provided the amount of the expenditures can be determined with reasonable accuracy.

You will be considered to have paid or incurred a rehabilitation expenditure only if you perform the rehabilitation yourself, or if someone else performs the rehabilitation based on your specifications.

However, if someone else pays or incurs rehabilitation expenditures and you acquire the property or an interest in the property upon which these expenditures are incurred before such property is placed in service, you may elect to depreciate these expenditures over the 60–month period. The election will apply only if the rehabilitated property is not placed in service during the period beginning with the date on which the expenditures were paid or incurred and ending on the date on which you acquired an interest in the property.

Your rehabilitation expenditures that are treated as paid or incurred by you are the *lesser* of:

1) The expenditures paid or incurred before the date on which you acquired an interest in the property attributable to the expenditures, or
2) The part of your cost or other basis attributable to the rehabilitation expenditures paid or incurred before you acquired the interest in the property.

The part of your basis of the property not attributable to rehabilitation expenditures is depreciated under ACRS. If your property is excluded property under ACRS, you may use one of the other applicable depreciation methods.

Example 1. Bob Adams paid rehabilitation expenditures of $10,000 for an existing building on January 3, 1985, and then sold the building to Tom Lewis on June 1, 1985. If the property attributable to the expenditures was not placed in service by Mr. Adams during the period from January 3, 1985, to June 1, 1985, Mr. Lewis will be treated as having paid the expenditures.

Example 2. Ann Morrison, using the cash method of accounting, began the rehabilitation of a three-story building on January 11, 1985. Prior to May 1, 1985, she paid rehabilitation expenditures of $12,000. On May 2, 1985, Ann sold the building and the land to Sam Johnson for $35,000. The purchase price was allocated as follows:

Land	$ 8,000
Existing building	11,000
Property attributable to rehabilitation expenditures	16,000
Total purchase price	$35,000

The property attributable to the rehabilitation expenditures was placed in service by Sam on September 1, 1985. Sam may treat part of the $35,000 as rehabilitation expenditures paid or incurred by him. The rehabilitation expenditures paid by Ann ($12,000) are less than the part of the purchase price that is allocable to the property and that is attributable to these expenditures ($16,000). Therefore, Sam may treat only $12,000 as rehabilitation expenditures paid or incurred by him. The $4,000 excess of the purchase price allocable to rehabilitation expenditures ($16,000) over the rehabilitation expenditures ($12,000) paid by Ann does not qualify for treatment under the election, but may be depreciated under ACRS as low-income housing real property.

Example 3. The facts are the same as in Example 2, except that the portion of the purchase price allocable to rehabilitation expenditures is $10,000. Under these circumstances, Sam Johnson may treat only $10,000 of Ann Morrison's $12,000 expenditures as rehabilitation expenditures paid or incurred by him. The $2,000 excess does not qualify for the election.

Binding contract. Rehabilitation expenditures incurred under a binding contract entered into before 1987 are deemed incurred before 1987. The contract must require the rehabilitation to be done for you in accordance with your specifications or for you to do the work yourself.

The contract as of December 31, 1986, must specifically identify the existing building(s) for

which you will incur the rehabilitation expenditures. You must actually incur the expenditures.

The contract is binding even if it is subject to certain contingencies which have not occurred by January 1, 1987. However, the contingencies (such as obtaining financing from a third party) must not be under your control and must actually occur. A contract is not a binding contract if it is not a bona fide agreement negotiated at arms-length.

A binding contract includes an agreement that you enter into with the Department of Housing and Urban Development (HUD) or a public housing agency (PHA) under section 8 of the United States Housing Act of 1937 which provides that HUD or PHA will make a housing assistance payments contract when the rehabilitation is completed.

Placed in service. Your rehabilitated property is considered placed in service on the date on which it is first placed in a condition or state of readiness and availability for a specifically assigned function, whether in the production of income, in a tax-exempt activity, or in a personal activity. Each dwelling unit of rehabilitated property is considered separately in determining the date on which it was first placed in service.

Rehabilitation starts when the physical work on a unit begins. Whether rehabilitation has started is based on the facts and circumstances in each situation.

Rehabilitated property, which is attributable solely to a single dwelling unit, is placed in service on the date that dwelling unit is placed in service. Rehabilitated property, which relates to more than one dwelling unit or which relates to common areas or related facilities and is allocated to more than one dwelling unit, will be considered placed in service on the earliest date a significant number of the units are placed in service.

If dwelling units are occupied on a rental basis at the time of rehabilitation, the property attributable to the expenditures will be considered placed in service on the date on which the rehabilitation of the units is substantially completed.

Example 1. In rehabilitating a 20 dwelling-unit apartment building, Frank King replaces the roof of a building. The new roof is considered as placed in service on the earliest date a significant number of the 20 rehabilitated dwelling units are placed in service.

Example 2. Mike Paige began the rehabilitation of his building on April 2, 1985. The building consists of five dwelling units. The tenants remained in the dwelling units during and after the rehabilitation. Work consisted of replacing plumbing facilities, installing light fixtures, and replacing windows. The rehabilitation of Unit 1 was substantially completed on May 2, 1985. The property attributable to Unit 1 expenditures is considered placed in service on that date. If the five units were rehabilitated at one time, the property would be considered placed in service when the work was substantially completed for all five units.

Limits. The minimum amount of rehabilitation expenditures that may qualify for the 60–month period must exceed $3,000 per dwelling unit in 24 consecutive months.

Example. Sue Brown spends $7,000 in 1985 to rehabilitate two dwelling units. She spends $5,000 to rehabilitate Apartment 101 and $2,000 to rehabilitate Apartment 102. The expenditure on Apartment 101 will qualify for the 60–month depreciation treatment. The expenditure on Apartment 102 will qualify only if more than $1,000 is incurred or spent solely on Apartment 102 in either 1984 or 1986.

Special rule. If rehabilitation expenditures are paid or incurred by a person other than yourself, and you acquire the property before it is placed in service, you will be considered as having paid or incurred rehabilitation expenditures on the date on which these expenditures were paid or incurred by the person actually making these expenditures.

If, however, no tax year of yours includes such date, then the limits on rehabilitation expenditures shall be applied by taking into account the period ending 24 full months after the date on which the expenditures were actually paid or incurred.

The maximum amount of rehabilitation expenditures for any dwelling unit that will qualify for the 60–month deduction is $20,000. Expenditures of more than that amount may be depreciated under other applicable methods.

The maximum amount of rehabilitation expenditures after 1980 is ***$40,000*** per unit if the rehabilitation is conducted under a program certified by the Secretary of Housing and Urban Development or by a state or local government unit and:

1) The certification of development costs is required,
2) The tenants occupy the units as their principal residences, and
3) The tenants who show home ownership responsibilities may purchase their units at a price that limits the profit to the seller.

The sum of the seller's taxable income from leasing and the amount realized on sale or other disposition must not be more than the excess of (1) the seller's cost basis in the property (not reduced for depreciation deductions) over (2) the net tax benefits from the depreciation deductions minus the tax on the taxable income from leasing.

Example. Alice Kirk makes the following rehabilitation expenditures, which do not qualify for the $40,000 maximum, for a single dwelling unit:

1982	$ 500
1983	2,000
1984	7,000
1985	12,000

The $500 expenditure for 1982 is under the $3,000 minimum amount for two consecutive years and may not be taken into account in computing depreciation using a 60–month useful life. The $9,000 total for 1983 and 1984 will qualify. However, only $11,000 of the 1985 expenditures may be included because of the $20,000 maximum limitation.

Allocation of expenditures. Amounts spent for more than one dwelling unit must be allocated among the dwelling units. Such expenditures must be allocated in the same ratio as the area of each dwelling unit bears to the total area of all dwelling units to which the expenditures are attributable.

Expenditures for related facilities solely for use by tenants of dwelling units, such as a parking lot, must be allocated among the dwelling units to which they relate in the same way as described above.

Expenditures for facilities serving both dwelling and non-dwelling units must be allocated among the dwelling and non-dwelling units they serve.

Expenditures for common areas such as stairways, corridors and entrances must be allocated among the particular dwelling and non-dwelling units they serve. No allocation is required in any case where you can demonstrate the actual amount of expenditures for a particular dwelling unit.

Expenditures for commercial units and facilities related only to the commercial units may not be allocated to dwelling units.

Example. John Ward spent $80,000 to replace the roof of his apartment building and to install a new heating system. There are 25 apartment dwellings of varying size in the building. Apt. No. 1 contains 1,000 square feet, and Apt. No. 2 contains 2,000 square feet. The entire building contains 36,000 square feet, of which 25,000 square feet is apartment dwellings, 5,000 square feet is occupied by a retail store, and the remaining areas are common areas. Of the 6,000 square feet of common areas, 1,000 square feet ((5,000/30,000) × 6,000) is allocated to the retail store and 5,000 square feet (25,000/30,000 × 6,000) is allocated to dwelling units. Since 5/6 of the total floor space (30,000/36,000) is attributable to the dwelling units, the dwelling units are allocated $50,000 (5/6 × $60,000) and the commercial units are allocated $10,000 (1/6 × $60,000). Thus, Apt. No. 1 is allocated $2,000 (1,000/25,000 × $50,000) and Apt. No. 2 is allocated $4,000 (2,000/25,000 × $50,000).

Property requirements. Rehabilitation expenditures are amounts chargeable to the capital account for depreciable property with a useful life of at least 5 years. The expenditures must be in connection with rehabilitating an existing building for low-income rental housing. The building need not have been residential property before rehabilitation began. Expenditures made to a dwelling unit are not considered rehabilitation expenditures, unless, following the completion of rehabilitation, the dwelling unit is held for rental to low or moderate income tenants.

Expenditures to buy land, a building, or a leasehold in a building are not rehabilitation expenditures. Neither are expenditures for a commercial unit, such as a grocery store.

You do not have to spend money ***directly*** on a dwelling unit or on a building for the expenditure to qualify as a rehabilitation expenditure. However, the expenditure must be in connection with the rehabilitation of an existing building and not attributable to a commercial unit. For example, expenditures to pave a parking lot for the use of tenants may qualify.

New construction. Expenditures for new construction are generally not rehabilitation expenditures. Whether expenditures are for an existing structure or for new construction is based upon all the facts and circumstances. An expenditure will generally qualify if the foundation and outer walls of an existing building are retained. If the internal structural framework and one or more of the outer walls of a building are replaced, the expenditures will generally constitute new construction even though the construction may be considered rehabilitation under local law. Other factors that may be relevant in this determination include:

1) The amount paid to acquire the existing building, and
2) The amount of material remaining from the existing building.

Enlargement of existing building. The total area occupied by dwelling units in a rehabilitated building may not be more than the total area of the existing building before rehabilitation. Any enlargement of an existing building for dwelling units will constitute new construction and will not qualify. However, expenditures for construction of a related facility, such as a garage, sidewalk, or parking lot, will not be considered an enlargement of a building for dwelling units, even if the facility is physically

attached to the building and may qualify for the 60–month depreciation.

Example 1. Jack Yale owns a two-story apartment building with an empty attic that he planned to rehabilitate. He also built two new apartments in the space formerly occupied by the attic. The expenditures may qualify as rehabilitation expenditures. However, if he adds a third story, the expenditures for the third story are to enlarge an existing building and will not qualify as rehabilitation expenditures.

Example 2. Peggy James owns an apartment building. As part of the rehabilitation of the existing structure, she built a garage, which is to be used only by the tenants. The expenditures attributable to the garage may qualify as rehabilitation expenditures to the extent the garage is used by tenants of the rehabilitated dwelling units.

Low-income rental housing. This type of housing is any dwelling unit in a building housing families and individuals of low or moderate income (discussed later) even if other dwelling units in the same building are not held for occupancy by persons of low or moderate incomes. However, if all the occupants of a dwelling unit are students, of whom none are entitled to file a joint return, they are not considered individuals or families of low or moderate income.

A dwelling unit is a house or apartment used to provide living accommodations in a building or structure. The dwelling unit need not be occupied subject to a lease. However, a dwelling unit does not include any unit in a hotel, motel, inn, or other establishment in which more than one-half of the dwelling units are used on a transient basis. A dwelling unit is used on a transient basis if it is occupied for more than one-half the days in which you rent the unit during the taxable year by a tenant or series of tenants, each occupying the unit for less than 30 days. If your dwelling unit is occupied subject to a sublease, you make the determination of whether a unit is occupied on a transient basis with respect to the sublessee who occupies the unit, not with respect to the lessee.

If your dwelling unit is rented for one or more periods during the tax year, beginning after the date on which the rehabilitated property is placed in service, it will be considered low-income rental housing only if it is occupied by families of low or moderate income during each such period.

If your dwelling unit is not rented for some period during the tax year beginning after the date on which the rehabilitated property is placed in service, it is considered low-income rental housing only if at all times during such period the rental at which the unit is offered indicates that it is held for occupancy by families and individuals of low or moderate income. Generally, if the rental at which the unit is offered is not more than 30% of the low or moderate income level for the number of persons occupying comparable units, the unit will be considered low-income rental housing.

Low or moderate income occupants. Expenditures paid or incurred before 1987 will qualify as rehabilitation expenditures, if your dwelling units are held for occupancy on a rental basis for individuals and families of low or moderate income.

The occupants are considered families and individuals of low or moderate income only if their adjusted income is not more than 80% of the median income for the area. This is the median income determined with adjustments for smaller and larger families by the Secretary of Housing and Urban Development (HUD). If the Secretary of HUD sets an income ceiling higher or lower than 80% of the median for the area, the higher or lower income ceiling will apply.

Adjusted income. The adjusted income of a family or individual is the anticipated total annual income for the certification year.

The certification year for any person is the 12 month period which begins on the later of:

1) The date the property attributable to the expenditures allocated to the dwelling unit occupied by the person is placed in service, or
2) The date the person first occupies the dwelling unit on a rental basis, or signs a lease for that unit, whichever occurs first.

The adjusted income must be figured solely from the income certification, discussed later. Adjusted income is not affected by income earned or received in the certification year that is not included in the income certification.

The annual income of a family includes payments from all sources received by the family head (even if temporarily absent) and each additional member of the family household who is not a minor.

If the circumstances are such that it is not reasonable to anticipate a level of income over a 12–month period, a shorter period may be used subject to a redetermination at the end of this period.

Adjusted income must be determined for the actual occupants of the dwelling unit. An occupant includes a family member who is not living in the dwelling unit, but whose income should be taken into account when computing adjusted income. The adjusted income is not affected by income earned in any year other than the certification year. Also, adjusted income is not affected by income earned or received during the certification year that is not included in income certification.

Income certification. To determine the adjusted income of a family or individual, you must obtain an income certification from the tenant covering each person who proposes to live in the dwelling unit after the beginning of the certification year.

If a dwelling unit is sublet during the year, you must obtain an income certification from the subtenant covering each person who proposes to live in the unit after the beginning of the certification year. If a dwelling unit is rented to a new tenant or subtenant during the 60–month election period, a new income certification must be obtained from each new tenant or subtenant covering each person who proposes to live in the unit after the beginning of the certification year.

The income certification must contain a statement of anticipated ***total annual income,*** discussed earlier, for the certification year for each person who proposes to live in that dwelling unit for that year. It should also contain the number of minors and the anticipated total annual income of the minors.

A ***minor*** is a member of the family household (excluding foster children), other than the family head or spouse, who is under 18 or is a full-time student.

Example 1. The median family income in a particular area is $12,000 for a family of four. During 1984, Mr. James spends more than $3,000 per unit in rehabilitating three two-bedroom dwelling units. All three units are placed in service on January 3, 1985, and are advertised at $200 per month. Two of the units are rented at this price to tenant A and tenant B, of whom each is married and has two children.

At the time of the signing of the lease, tenant A certifies that his family's adjusted income for their certification year (the 12–month period beginning on the date the lease is signed) is $9,000. Family A's adjusted income of $9,000 is not more than the low or moderate income level (80% of $12,000). Therefore the rehabilitation expenditures allocated to the dwelling unit rented to tenant A qualify for depreciation under the 60–month life.

Tenant B, at the time of signing his lease, certifies that his family's adjusted income for their certification year is $10,000. The rehabilitation expenditures allocated to the dwelling unit rented to tenant B will not qualify, since tenant B's adjusted income ($10,000) is more than 80% of the maximum local eligibility level (80% of $12,000 = $9,600) for that area. The remaining unit was vacant throughout 1985. It will be considered low-income rental housing since the rental at which the unit is offered ($2,400 per year) is not more than 30% of the low or moderate income level for a family of four, $2,880 (30% of $9,600).

Example 2. Tenant A's wife, in Example 1, takes a job during 1985 and earns $3,600, giving the family a total income of $12,600. Even though A's adjusted income would not now qualify for that certification year, the original election with respect to property contained in the dwelling unit rented to tenant A will remain valid as long as A occupies the unit.

Making the election. To elect the 60–month depreciation period for rehabilitation property, attach Form 4562 to your income tax return and enter your deduction in Part I, Section C. For the ***first*** tax year for which you compute depreciation using a 60–month useful life, also attach a statement to your income tax return that contains:

1) Your name, address, and employer identification number or social security number,
2) A description of the property for which the election is made and the date the property was placed in service,
3) The location and description of the building being rehabilitated,
4) The number of dwelling units in the building and the number occupied on a transient basis,
5) The date on which the rehabilitation expenditures were incurred,
6) A statement that all income certifications have been obtained,
7) For each dwelling unit which you seek to qualify as low-income housing you must show—
   a) Rehabilitation expenditures allocated to that unit,
   b) For each occupancy period during the year, the number of occupants, the maximum income level permissible for that number of occupants, the adjusted income of the occupants (determined from the income certificates), the method by which the income was determined, and the rent charged for each unit, and
   c) For each period in which a unit is vacant during the year, a description of each unit (number of rooms), the low or moderate income level in that area for the number of persons occupying comparable units, and the rental at which each vacant unit is offered,
8) If you must allocate your rehabilitation expenditure, the area occupied by dwelling units and nondwelling units,
9) If applicable, a statement of intent to fulfill the $3,000 minimum amount limitation, and
10) If you are treated as having paid or incurred rehabilitation expenditures paid or incurred by another taxpayer, the amount

of such expenditures, the date they were incurred, the date the property was placed in service, the method of accounting used by the person that made the expenditures, and the purchase price of the rehabilitation property.

The election period begins on the date that the property is placed in service, described earlier, unless you adopt an averaging convention permitting use of another date.

Individuals, estates, and trusts that make this election must attach Form 6251 to their return even if they are not liable for the alternative minimum tax.

For each subsequent year in which you compute depreciation using a 60–month useful life you must file a statement with your return showing:

1) The rental charges for each occupied unit and the rental charge at which each vacant unit is offered, and
2) If any unit is rented to a new tenant during the tax year the statement must include—
   a) That each new tenant has signed an income certification,
   b) The number of occupants in each unit,
   c) The maximum income permissible for that number of occupants, and
   d) The total adjusted income of the occupants determined solely from income certifications.

Time for filing the election. In general, the election to depreciate under the 60–month useful life must be filed no later than the date (including extensions) on which you are required to file your return for the tax year in which the property is placed in service, provided the rehabilitation expenditures meet the requirements in the year taking into account expenditures of the preceding tax year for the $3,000 minimum amount limitation.

The statements required for subsequent years must be filed no later than the time required to file your income tax return (including extensions) for each subsequent year. However, if you do not file a timely return for the year in which you place the property in service, you should file the election at the time that you file your first return for that year. If you do not make an election within the time prescribed, you may not make this election by filing an amended return or in any other manner, except as provided in the following paragraph for the $3,000 minimum amount limitation.

Special rule. If you fail to satisfy the $3,000 minimum amount limitation in the tax year in which the property is placed in service and in the immediately preceding tax year, you may make an election for the tax year in which the property is placed in service. You should file the election and enclose a separate written statement of intent to fulfill the minimum amount limitation in your next tax year. If you do not file an election for the tax year that the property is placed in service, you may file an election with an amended return for that year no later than the due date (including extensions) for filing a return for the first tax year following the year that you placed the property in service.

Example. David Holt makes rehabilitation expenditures of $2,000 per dwelling unit in two consecutive tax years beginning in 1984. David may elect to depreciate the expenditures over a 60–month period for the property placed in service in 1984, even though the 1984 tax return is due before David has paid or incurred any expenditures in 1985, providing he files a statement of intent to spend more than $1,000 per dwelling unit in 1985. As an alternative, David can make the election on an amended 1984 return.

Revocation of election. You may revoke an election to depreciate rehabilitation expenditures over a 60–month period at any time before the due date (including extensions) for filing a return for the last tax year in which any portion of the 60–month election period falls. To make the revocation, you should file a written statement with the District Director or the Director of the Internal Revenue Service Center with which the election was filed.

The revocation will not affect the years in which you computed the depreciation deduction under the 60–month period. The revocation will be effective on the date that you specify. You may make the revocation for expenditures allocated to any dwelling unit in a building or structure, or to the entire property. A revoked election may not be reinstated.

Your failure to meet the requirements for depreciation over a 60–month period will be considered to have revoked your election if, at any time during the tax year:

1) A dwelling unit is rented to, or held for occupancy by a family, or by an individual not of low or moderate income,
2) More than half of the building's dwelling units on which you made rehabilitation expenditures are rented on a transient basis, or
3) You do not make sufficient expenditures to meet the $3,000 minimum amount limitation for the preceding tax year.

The revocation is effective on the first day that you fail to meet the requirements for depreciation of rehabilitation expenditures over a 60–month period. However, revocation will not affect depreciation taken before the year of revocation, provided all the requirements for the 60–month writeoff were met for those years. A revoked election may not be reinstated.

Effect of revocation. You may not compute depreciation using the 60–month useful life for any part of the tax year beginning after the date the revocation is effective. The depreciation deduction using the 60–month useful life for the part of the tax year in which the revocation is effective will be the amount the deduction would have been for the year if no revocation had occured, multiplied by a fraction consisting of:

1) The number of days in the year prior to the date of the revocation, over
2) The number of days of the 60–month election period which fall within the year.

After the revocation, you depreciate the property using the ***straight line*** method. You use an estimated remaining useful life and salvage value determined as of the date of revocation. Your adjusted basis for depreciation, after the revocation, is your original basis, less the depreciation allowed under the 60–month rule.

If you wish to adopt another depreciation method following revocation, the change will require the consent of the Internal Revenue Service. Generally, the straight line method of depreciation using your property's remaining useful life will be the only depreciation method accepted following a revocation.

10. Depletion

If you own mineral property, an oil, gas, or geothermal well, or standing timber, you may be able to take a deduction for depletion.

The depletion deduction may be available to you as an owner and an operator if you have an economic interest in mineral deposits or standing timber.

You have an economic interest if you have a legal interest in minerals in place or standing timber and you have the right to income from the extraction and sale of the mineral or the cutting of the timber to which you must look for a return of your capital. More than one party may have an economic interest in a mineral deposit if each qualifies. If you have no legally enforceable right to share in the minerals in place, you do not have an economic interest in that mineral.

Depletion, whether cost or percentage, is figured separately for each property. A property is each separate interest you own in each mineral deposit in each separate tract or parcel of land. Various special rules let you group separate properties or treat such properties as separate.

Individuals, estates, and trusts that claim depletion deductions must attach Form 6251, *Alternative Minimum Tax Computation,* to their return even if they are not liable for the tax.

Figuring the Deduction

There are two ways of figuring depletion: cost depletion and percentage depletion. Percentage depletion does not apply to timber.

Cost depletion is usually figured by dividing the adjusted basis of the mineral property by the total number of recoverable units in the deposit, and multiplying the resulting rate per unit:

1) By the number of units sold for which you receive payment during your tax year, if you use the cash receipts and disbursements method, or
2) By the number of units sold, if you use the accrual method of accounting.

The adjusted basis is your original cost or other basis of the mineral property plus any capitalized costs minus all the depletion allowed or allowable on the property. Depletion allowed or allowable each year is the greater of percentage depletion or cost depletion. However, the adjusted basis may never be less than zero.

The number of units in place in a natural deposit is mainly an engineering problem. It is your responsibility to prove, by using accepted methods, the number of recoverable units.

Percentage depletion is a certain percentage, specified for each mineral, of your gross income from the property during the tax year, but the deduction for depletion under this method cannot be more than ***50%*** of your taxable income from the property figured without the deduction for depletion.

The use of percentage depletion for oil and gas is not allowed except for certain domestic production (production from certain domestic gas wells and that of independent producers and royalty owners of oil and gas wells). If you are a qualified independent producer or royalty owner of oil and gas (small producers, discussed later under *Oil and Gas Wells*), the deduction for depletion may not be more than ***65%*** of your taxable income (reduced for an individual by the zero bracket amount) from all sources figured without the depletion allowance, any net operating loss carryback, and any capital loss carryback.

Rents and royalties (which are depletable income to the payee) you pay or incur for the property must be excluded from your gross income from the property when figuring your percentage depletion.

50% limit. In figuring percentage depletion and the 50% limit for percentage depletion, you reduce your gross income from the property by the allocable part of any bonus you paid for a

mineral lease or an oil and gas lease on the property. You figure that part of the bonus by multiplying the total bonus that you paid by a fraction, the numerator (top number) of which is the number of units that you sold in that tax year and the denominator (bottom number) of which is the number of total estimated recoverable units from the property.

A net operating loss deduction is not deducted from gross income from the property for figuring the 50% limit.

Charitable contributions are not deducted from gross income from the property by a corporation in figuring the 50% limit.

You also must reduce mining expenses by any gain that you must report as ordinary income that is allocable to the property and results from the disposition of certain depreciable property.

A deductible payment to a nonqualified deferred compensation plan for employees with respect to mining properties is deducted in figuring the 50% limit.

Even if you have recovered your cost or other basis of the property, you may take a deduction for percentage depletion.

If you can use percentage depletion and it is less than cost depletion for any year, you must use cost depletion for that year.

Oil and Gas Wells

The use of percentage depletion for oil and gas is not allowed, except for certain domestic gas and oil production. In general, the percentage depletion rate is 15% of the gross income from the qualifying production from oil and gas property.

Fixed contract. Income from natural gas sold under a fixed contract from a well located in the United States or its possessions qualifies for percentage depletion at 22%. Independent producers and royalty owners (small producers) may use percentage depletion with certain limits.

Natural gas sold under a fixed contract is domestic gas that is sold by the producer under a contract in effect on February 1, 1975, and at all times thereafter before the sale. The price must not be adjusted to reflect the increase in the liability of the seller for tax because of the change in the law regarding percentage depletion for gas. Price increases after February 1, 1975, are presumed to take such liability into account unless the taxpayer can demonstrate to the contrary by clear and convincing evidence.

Independent producers and royalty owners (small producers) qualify for a 15% rate for a maximum daily average of 1,000 barrels (6,000 cubic feet of natural gas is the equivalent of a barrel of oil). This is the small-producer exemption.

You do not qualify for the small-producer exemption if you or a related person engage in the refining of crude oil and your refinery runs exceed 50,000 barrels on any day during the tax year. You also may not qualify for this exemption if you, directly or through a related person, sell oil or natural gas, or any product derived from oil or natural gas, through a retail outlet or to certain persons who are required to use a trademark or trade name owned by you or a related person in marketing or distributing oil or natural gas, or to any person given authority to occupy any retail outlet of yours or of a person related to you.

However, you may qualify for the exemption if the combined gross receipts of all retail outlets are not more than $5,000,000 from the sale of oil or natural gas (excluding bulk sales to commercial or industrial users), or any other product derived from oil or natural gas (excluding bulk sales of aviation fuels to the Department of Defense), for the tax year. Also, for this purpose, sales of oil, natural gas, or products that are derived from oil or natural gas do not include sales you make outside the United States if none of your domestic production or that of a related person is exported during the tax year or the preceding tax year.

You do not qualify for the small-producer exemption if you received your interest in a proven oil or gas property by transfer after 1974. However, the term "transfer" usually does not include a transfer at death, nor does it include certain transfers to controlled corporations, certain changes of beneficiaries of a trust, transfers between businesses under common control or between members of the same family, transfers between a trust and related persons in the same family, and certain transfers by individuals to corporations.

However, an election by a corporation to become an S corporation is treated as a transfer of all its properties on the day on which the election first takes effect. Likewise, if an S corporation ceases to be an S corporation and becomes a regular corporation, each shareholder is treated as transferring to the corporation the shareholder's pro rata share of all the S corporation's assets.

If you have a part interest in property, you have production from that property that is in proportion to your interest. If your average daily production for the calendar year is more than 1,000 barrels (or 6,000,000 cubic feet of gas), you must divide the small-producer exemption among all of the properties in which you have an interest.

Allocation of the exemption must be made among corporations that are members of the same controlled group (the common control test is 50%); among corporations, trusts, and estates if 50% of the beneficial interest is owned by the same or related persons (considering only persons that own at least 5% of the beneficial interest); and among the producers or royalty owners and their spouses and minor children.

Gross income from oil and gas property (including geothermal steam wells) is the amount you receive from the sale of the oil or gas in the immediate vicinity of the well (at the well-head). If you do not sell the oil or gas on the property, but manufacture or convert it into a refined product before sale or transport it before sale, the gross income from the property is the representative market or field price of the oil or gas at the well-head as of the date of sale, before conversion or transportation.

Natural gas from geopressured brine. Qualified natural gas from geopressured brine is eligible for percentage depletion at the rate of 10%.

Partnership oil and gas properties. For partnership property the depletion allowance, whether cost or percentage, must be figured separately by each partner and not by the partnership. This is so because only the partner will have the necessary information to determine the 65% limitation of taxable income, as discussed earlier under *Percentage depletion*. This limitation is applied to the partner's taxable income from all sources, and not just to taxable income from the property. In addition, as discussed next, only the partner can determine that partner's share of adjusted basis of oil and gas properties used in the computation of cost depletion or to figure any subsequent gain or loss if the property is disposed of by the partnership.

In order for the partner to compute cost depletion, the partnership must ***first*** allocate to each partner that partner's share of the adjusted basis of each partnership oil or gas property that was acquired by the partnership. This allocation must be made as of the date the partnership acquires the oil or gas property or January 1, 1975, whichever is later. The partner's share of the adjusted basis of the oil or gas property is figured by the amount of that partner's interest in partnership capital or income or as determined by a partnership agreement as to any property contributed to the partnership by that partner.

Secondly, after receiving such information from the partnership, each partner must keep this information separately. Thereafter, in those separate records, the partner must reduce the share of the adjusted basis of each property by the amount of depletion taken on the property each year by that partner, and use that adjusted basis, as reduced, in the computation of any cost depletion or to figure any gain or loss if the property is later disposed of by the partnership.

Reporting the deduction. The oil and gas partner reports and deducts depletion on Schedule E (Form 1040), *Supplemental Income Schedule*. The partner uses the *Partnerships and S Corporations* section of Part II (Schedule E), *Income or Losses from Partnerships, S Corporations, Estates, or Trusts*, to enter his or her net income or loss from the partnership. The partner's share of the net income or loss from the partnership, before depletion, is recorded on the same line for which the partner enters the name of the partnership and the employer identification number. On the next line, the partner enters the depletion deduction, and nets it against the income or loss amount. A partner who is entitled to a depletion deduction from more than one oil and gas partnership makes this computation for each partnership.

In addition to completing Schedule E, the partner may also have to complete Schedule SE (Form 1040), *Computation of Social Security Self-Employment Tax*, if partnership net income is considered net earnings from self-employment. For more information, see Publication 533, *Self-Employment Tax*.

S corporation oil and gas properties. The depletion allowance is figured separately by each shareholder of an S corporation in the same way as a partner in a partnership.

For an S corporation shareholder to compute cost depletion, the S corporation must allocate to each shareholder that shareholder's basis of each oil or gas property held by the S corporation. The allocation is made as of the date the corporation acquires the property or, if later, the first day of the first tax year to which the Subchapter S Revision Act of 1982 applied. The Act was effective for tax years beginning in 1983. For calendar year S corporations, this date was January 1, 1983.

Each shareholder must separately keep records of the shareholder's pro rata share of the adjusted basis in each oil and gas property of the S corporation. Thereafter, the shareholder must adjust the share of the adjusted basis for any depletion taken on the property by the shareholder and use the adjusted basis each year to compute cost depletion or to compute the shareholder's gain or loss on the disposition of the property by the S corporation.

For any distribution of the oil or gas property to its shareholders by the S corporation, the corporation's adjusted basis in the property is the total of all the shareholders' adjusted bases in the property.

Natural and Geothermal Deposits

Mines and other natural deposits, including geothermal deposits, qualify for percentage depletion.

Mines and other natural deposits. The percentage of your gross income from a natural deposit that you may deduct as depletion is based upon the type of deposit being mined.

Some of the depletion percentages for the more common minerals follow:

DEPOSITS	PERCENT
Sulphur and uranium; and, if from deposits in the United States, asbestos, lead, zinc, nickel, mica, and certain other ores and minerals	22
Gold, silver, copper, iron ore, and oil shale, if from deposits in the United States	15
Coal, lignite, and sodium chloride	10
Clay and shale used in making sewer pipe or bricks or used as sintered or burned lightweight aggregates	7½
Clay (used or sold for use in manufacture of drainage and roofing tile, flower pots, and kindred products), gravel, sand, and stone	5
Most other minerals, including carbon dioxide (CO_2) produced from a well, and metallic ores	14

Reduction of percentage depletion for corporations. The percentage depletion deduction of a corporation for iron ore and coal (including lignite) is reduced by 15% of the excess of:

1) The amount of the percentage depletion deduction for the tax year, over
2) The adjusted basis of the property at the close of the tax year (determined without the depletion deduction for the tax year).

Gross income from a mining property is the gross income from extracting ores or minerals from the ground, transporting them not more than 50 miles from the point of extraction to the plant or mill in which a recognized mining treatment process is applied. Treating processes that are included as mining depend upon the ore or mineral mined, and usually include those processes needed to make the mineral first suitable for sale or consumption. This usually means processing to a shipping grade and form. However, in certain cases, additional processes specified in the law are included as mining. To qualify as mining, the treatment processes must be applied by the mine owner or operator.

Gross income from mining property also includes the separately stated excise tax received by a mine operator from the sale of coal which the mine operator must pay to finance black lung benefits.

Transportation of more than 50 miles. If the Internal Revenue Service finds that the physical and other requirements are such that the ore or mineral must be transported more than 50 miles to plants or mills to be treated, the entire transportation will be included as mining. If you wish to include transportation of more than 50 miles as mining, you must file an application, in duplicate, setting forth the facts, with the Internal Revenue Service, Washington DC 20224, Attention: Corporation Tax Division, Engineering and Valuation Branch, CC:C:E.

To figure your depletion allowance for mineral properties, you should figure it under both the cost and percentage depletion methods for each property, and claim a deduction for the greater of the two amounts.

Geothermal deposits. Geothermal deposits qualify for percentage depletion at the rate of 15%. A geothermal deposit is a geothermal reservoir of natural heat stored in rocks or in a watery liquid or vapor. It is not considered a gas well. Geothermal deposits located outside the United States or its possessions do not qualify.

Lessor's Gross Income

A lessor's gross income from the lease of gas, oil, or mineral property for percentage depletion usually is the sum of the royalties received from the lease, excluding rentals that are not payment for units of mineral produced or to be produced.

Bonuses and advanced royalties are payments that a lessee makes to a lessor as consideration for the lease or for minerals, gas, or oil that are to be extracted from leased property. Both types of payments are made in advance of production. If you are the lessor, your income from bonuses and advanced royalties may be subject to an allowance for depletion.

If you receive a bonus or advanced royalty, you should figure the depletion allowance using both the cost depletion and the percentage depletion methods. Then select the method that gives you the larger deduction to figure the depletion allowance for your return. When you use percentage depletion, the bonus or advanced royalty payments are part of your gross income from the property.

Terminating the lease. For bonuses, if a lease is terminated with no production, you must include in income the depletion deduction you took on the bonus in advance of production. You must also increase your basis in the property to restore the depletion deduction you previously subtracted from your basis.

For advanced royalties, you must restore the depletion you claimed on minerals for which the advanced royalties were paid if the mineral was not produced prior to termination. You must increase your basis in the property by the amount you include in income.

Delay rentals are payments for deferring development of the property. These rentals can be avoided by abandoning the lease, by beginning development operations, or by obtaining production. Since delay rentals are ordinary rent, these amounts received by a lessor are ordinary income that is not subject to depletion.

Timber

You may figure timber depletion only by the cost method. Percentage depletion does not apply to timber. Your depletion is based on your cost or other basis in the timber. Your cost does not include any part of the cost of the land.

Figuring the deduction. Because depletion takes place when standing timber is cut, you may figure your depletion deduction only after the timber is cut and the quantity is first accurately measured. At the end of your tax year include in your closing inventory of products cut from timber as a cost item any allowable depletion on the timber from which the unsold products are cut.

You figure your depletion allowance for your tax year by multiplying the number of timber units cut by your depletion unit. Your depletion unit is your cost or adjusted basis of the standing timber on hand divided by the total depletable units, such as thousand board feet (MBF), cords, etc.

Example. You bought a timber tract for $160,000 and the land was worth as much as the timber. Your basis for the timber is therefore $80,000. You figure your depletion unit to be $80 per MBF, based on an estimated one million board feet (1,000 MBF) of standing timber. If you cut 500 MBF of timber your depletion allowance would be $40,000 (500 MBF at $80 per MBF).

You claim your depletion allowance as a deduction in the year of the sale or other disposition of the products cut from the timber, unless you elect to treat the cutting of timber as a sale or exchange. In the above example, if you cut 500 MBF of your timber in 1985 and sold the logs in 1986, you would deduct your depletion allowance in 1986, the year of the sale.

Electing to treat the cutting of timber as a sale or exchange. You may elect, under certain circumstances, to treat the cutting of timber as a sale or exchange. If you make this election, subtract the adjusted basis for depletion from the fair market value of the timber at the beginning of the tax year in which it is cut to figure the gain to report on the cutting. You generally report the gain as long-term capital gain. The fair market value then becomes part of your basis for figuring your ordinary gain or loss on the sale or other disposition of the products cut from the timber. See Publication 544, *Sales and Other Dispositions of Assets.*

Form T. Attach Form T, *Forest Industries Schedules,* to your income tax return if you claim a deduction for depletion of timber.

Sale or Lease of Property

If you sell all your economic interest in a property and keep no continuing interest or reverting interest in it, any gain usually is capital gain. If you grant operating rights in property and keep a royalty interest in it, you have made a lease. The amount you receive for the assignment, as well as any royalty income you collect (other than certain situations involving timber, coal, or domestic iron ore), is ordinary income subject to a depletion allowance.

Royalty payments you receive under a surface lease are ordinary income received in return for the right to use the surface overlying the minerals. A surface lease gives the lessee the right to enter and use or destroy surface lands for the purpose of prospecting for and extracting minerals.

Disposal of coal, iron ore, or timber with a retained economic interest may result in a capital gain equal to the difference between the amount realized and the adjusted basis for depletion rather than ordinary income under certain circumstances. If you dispose of the coal, iron ore, or timber and are entitled to treat the gains as a capital gain, you may not take a depletion deduction.

11. Other Expenses

This discussion briefly covers some of the expenses you, as a person engaged in business, may have that are not explained earlier in this publication. Some of these expenses are deductible, and some are not deductible.

The expenses are presented in alphabetical order by the kind of expense. In the case of some expenses, you can find more information in another publication. Where this is so, the number and title of the other publication is given, and it usually appears near the end of the discussion of the expense.

If you use the accrual method of accounting, your deduction for the following expenses will depend on when economic performance occurs. The economic performance rule is discussed under *When Can an Expense Be Deducted?* in Chapter 1.

Advertising expenses. You may deduct advertising expenses if they are reasonable and they bear a reasonable relationship to your business activities. You cannot deduct the cost of advertising if its purpose is to promote or defeat legislation.

Expenditures for institutional or goodwill advertising to keep your name before the public are usually deductible as an ordinary and necessary business expense if they are related to the amount of business you may reasonably expect in the future. For example, the cost of advertising that keeps your name before the public by encouraging people to contribute to organizations such as the Red Cross, to buy

U.S. Saving Bonds, or to participate in similar causes usually will be deductible.

Foreign country. Expenses you incur to advertise on foreign radio and television stations (including cable television) where the advertising is directed primarily to a market in the United States are not deductible. This rule will apply to foreign broadcast undertakings located in any country that denies a similar deduction for the cost of advertising directed primarily to a market in the foreign country when placed with a United States broadcast undertaking.

Anticipated liabilities. Anticipated liabilities or reserves for anticipated liabilities are not deductible. For example, assume that you sold one-year TV service contracts this year amounting to $50,000, and experience has shown that you will have expenses of $15,000 in the coming year for these contracts. The television sets covered by the contracts were not sold by you or by a person controlled by you.

You may not deduct any part of the $15,000 by creating a reserve for expected (or future) expenses and charging expenses to the reserve. You may deduct your expenses only when you actually pay or accrue them depending upon your method of accounting.

Black lung benefit trust contributions. If you, as a coal mine operator, make a contribution to a qualified black lung benefit trust, you may be entitled to a business deduction for the amount of your contribution. To be deductible, your contribution must be made during the tax year or paid to the trust no later than the due date for filing your federal income tax return (including extensions). The contribution must be made in cash or property that the trust is permitted to hold. If you contribute property, the transaction is considered a sale or exchange of the property. A contribution to the trust in the form of a note or other evidence of indebtedness of the operator is not considered a contribution to the trust.

You may figure your allowable deduction for contributions to a black lung benefit trust on Schedule A, Form 6069.

Bribes and kickbacks. You may not deduct bribes, kickbacks, or similar payments if they meet either of the following conditions:

1) They are payments made directly or indirectly to an official or employee of any government or an agency or instrumentality of any government in violation of the law. If the government is a foreign government, the payments are not deductible if they are unlawful under the Foreign Corrupt Practices Act of 1977,
2) They are payments (other than those described in condition (1) above) made directly or indirectly to any person in violation of any federal or state law (but only if that state law is generally enforced) that provides for a criminal penalty or for the loss of a license or privilege to engage in a trade or business.

Meaning of "generally enforced." A state law is considered to be generally enforced unless it is never enforced or is enforced only in the case of infamous persons or persons whose violations are extraordinarily flagrant. For example, a state law is considered to be generally enforced unless the proper reporting of a violation of the law does not result in enforcement action except under unusual circumstances.

A kickback includes a payment for referring a client, patient, or customer. The common kickback situation occurs when money or property is given to someone as payment for causing an employer, client, patient, customer, or principal to purchase from, use the services of, or otherwise deal with the person who pays the kickback. In many cases, the person whose business is being sought or enjoyed by the person who pays the kickback does not know of the payment.

Example 1. An insurance broker pays car dealers who refer insurance customers to the broker a part of the insurance commissions earned. The car dealers are not licensed to sell insurance. If these payments are made in violation of any federal or state law, as explained in condition (2) above, the broker may not deduct them.

Example 2. The Yard Corporation is in the business of repairing ships. It pays kickbacks of 10% of the repair bills to captains and chief officers of vessels it repairs. The Yard Corporation considers kickbacks necessary to get business. The owners of the ships do not know of these kickbacks.

In the state where the corporation operates, it is unlawful to attempt to influence the actions of any employee, private agent, or fiduciary in relation to the principal's or employer's affairs by giving or offering anything of value without the knowledge and consent of the principal or employer. The law is generally enforced. Therefore, the kickbacks paid by the Yard Corporation are not deductible.

Kickbacks, bribes, and rebates paid in connection with medicare or medicaid programs are not deductible.

File Form 1099–MISC. If you pay any kickbacks during your tax year, whether or not they are deductible on your return, you must file an information return, Form 1099–MISC, *Statement for Recipients of Miscellaneous Income,* for every person to whom you pay $600 or more during the year.

Car and truck expenses. You may deduct the cost of operating a car, truck, or other vehicle that you use in your business. Only the expenses for business use are deductible. Traveling between your residence and your place of business is not business use. All actual operating and fixed costs allocable to business use may be deducted. These costs include gas, oil, repairs, license tags, insurance, and depreciation.

Under certain conditions, you may use a standard mileage rate to figure your deduction instead of using actual costs. For more information on how to figure your deduction, see Publication 463, *Travel, Entertainment, and Gift Expenses.*

Recordkeeping. Although the contemporaneous recordkeeping rules were repealed for 1985, you are required to substantiate your expenses for use of a vehicle in your business. Starting after 1985 the adequate recordkeeping rules apply to your expenses for use of a vehicle in your business. See Publication 463.

Charitable contributions. Cash payments you make to charitable, religious, educational, scientific or similar organizations may be deductible as business expenses if the payments are not charitable contributions or gifts. If the payments are charitable contributions or gifts, you may not deduct them as business expenses. However, corporations may deduct charitable contributions on their income tax returns. See Publication 542, *Tax Information on Corporations.* If you are an individual, a partner in a partnership, or a shareholder in an S corporation, you may be able to deduct charitable contributions made by your business on your individual income tax return.

Example. You paid $15 to a local church for a half-page ad in a program for a concert it is sponsoring. Since your payment is not a contribution, you cannot deduct it as such. However, you may deduct it as an advertising expense.

Inventory. If you donate inventory, only costs or expenses pertaining to the inventory you had in earlier tax years and properly reflected in opening inventory for the year of contribution must be removed from opening inventory. They are not a part of cost of goods sold for purposes of figuring gross income for the year of contribution. Instead they are used in figuring the basis of the contribution.

However, any costs or expenses for the contributed property that you had in the year of contribution and that would be properly reflected in the cost of goods sold should be included in the cost of goods sold for that year. Those properly deductible as business expenses should be deducted in the year paid or incurred. However, these costs and expenses are not used in arriving at the basis for the contributed property.

Demolition expenses or losses. You cannot deduct any amount paid or incurred to demolish any structure, or any loss pertaining to the undepreciated basis of a demolished structure. Instead you must add these costs to the basis of the land on which the demolished structure was located.

Depreciation. If property you buy to use in your business has a useful life longer than one year, you may not deduct the entire cost as a business expense in the tax year when you buy it. Instead, you must spread the cost over more than one tax year and deduct a part of the cost each year. This method of deducting the cost of business property is called depreciation, and the deduction you take each year for part of the cost of your business property is your depreciation deduction.

There is an exception to this requirement to depreciate long-lived business property. You may choose to deduct in your tax year a limited amount of the cost of certain depreciable property you purchased in the tax year for use in your business. This deduction cannot be more than the cost of the depreciable property, and the most you may deduct for your tax year that starts in 1985 is $5,000.

For more information on deducting the cost of depreciable property, see Publication 534, *Depreciation.*

Dues and subscriptions. You may deduct membership dues you pay to trade or professional organizations. You may also deduct dues you pay to the Chamber of Commerce if the membership promotes your business interests.

Donations to other business organizations may be deducted as business expenses if they are directly related to your trade or business and you reasonably expect a financial return that is in line with the amount of your donation. For example, a contribution that you make to a committee organized by a chamber of commerce to bring a national convention to your city may be deductible. However, if a substantial part of the activities of the organization consist of lobbying, attempting to promote or defeat legislation, political campaigning, carrying on propaganda or advertising for any of these purposes, or any combination of these activities, you may deduct only the part of any payments you make to the organization that are not attributable to these activities.

The cost of subscriptions to professional, technical, and trade journals that deal with material in your business field is a deductible business expense.

Education expenses. There are two kinds of expenses for education that you may deduct. One of these is the ordinary and necessary expenses you pay for the education and training of your employees. These expenses are discussed in Chapter 2.

The other kind is for amounts you spend for your own education in your trade, business, or profession, along with certain related travel, including meals, lodging, and transportation expenses. To qualify, you must show that the education maintains or improves skills that are required in your trade, business, or profession or that it is required by law or regulations for keeping your pay, status, or job.

However, you may *not* deduct education expenses that you incur to meet the minimum requirements of your present trade, business, or profession, or those that qualify you for a new trade, business, or profession, even if such education maintains or improves skills that are presently required.

You should attach a statement to your return that explains the deduction and shows the relationship of the education to your trade, business, or profession.

Example 1. Dr. Carter, who is engaged in the private practice of psychiatry, begins a program of study and training at an accredited psychoanalytic institute that will lead to qualifying her to practice psychoanalysis. She may deduct the cost of the program because the study and training maintains or improves skills required of her in her profession and does not qualify her for a new one.

Example 2. Herb Jones owns a repair shop for televisions, radios, and phonographs. The bulk of the business is television repairs, but occasionally he fixes radio-phonograph combinations and stereo phonographs. To keep up with the latest technical changes, he takes special courses in radio and phonograph service. Since these courses maintain and improve skills required of him in his trade, he may deduct their cost.

Example 3. You have your own accounting practice. You take several courses in taxation and tax accounting. Since these courses improve skills required of you in your trade or business and are not part of a program of study qualifying you for a new trade or business, you may deduct them.

Example 4. Peter Green, an architect in business in New York, decides to take a special 2-week course on the latest building techniques. He goes to Los Angeles, devotes 2 weeks to the course in building techniques, spends 8 weeks in purely personal activity, and returns to New York.

The time he spent on personal activities indicates that his main reason for going to Los Angeles was to take a vacation, even though he took the course to improve skills required of him in his business. He may deduct his education expense and his expenses for meals and lodging during the 2 weeks spent pursuing his education. But none of the transportation expenses are deductible, and he may not deduct any of his expenses for meals and lodging for the 8 weeks spent in personal activities.

Travel as education. Your expenditures for travel as a form of education generally are deductible to the extent the major portion of your travel activity during the period of travel directly maintains or improves skills required of you in your employment, trade, or business. An employer's approval of the details of an employee's travel does not mean the travel is of the required nature.

Travel expenses are deductible if they are incurred primarily to obtain education, the expenses of which are deductible. See Publication 508, *Educational Expenses.*

Franchises, trademarks, trade names. Amounts you spend during the tax year to buy a franchise, trademark, or trade name are deductible as business expenses if the amounts depend on the productivity, use, or disposition of the franchise, trademark, or trade name.

The part of the payments you make to buy a franchise, trademark, or trade name that does not depend on its productivity, use, or disposition is treated according to whether or not the transferor keeps any significant power, right, or continuing interest in the subject of the franchise, trademark, or trade name. If not, the payments are part of the purchase price of a capital asset.

If the transferor keeps any significant power, right, or continuing interest, then the payments are deductible over a period of time as follows: A lump-sum payment of the amount agreed upon is deductible in equal amounts over the shorter of 10 years or the life of the agreement. Approximately equal installments payable over the period of the transfer agreement or a period that is more than 10 years are deductible in the year paid.

Interview expense allowances. Allowances or reimbursements you make to job candidates for transportation or other expenses in connection with interviews for possible employment are not wages subject to social security taxes (FICA), federal unemployment taxes (FUTA), or the withholding of income tax. However, you may deduct such allowances as a business expense.

Legal and professional fees. Legal and professional fees, such as fees charged by lawyers and accountants, that are ordinary and necessary expenses of operating your business are deductible as business expenses. However, legal fees you pay to acquire business assets usually cannot be deducted. They are added to the basis of the property.

If the fees you are charged for legal or professional services include payments for work of a personal nature (such as making out a will or preparing your personal income tax return), you may deduct only the part of the fee that relates to your business as a business expense. Some of the other fees may be deductible on Schedule A (Form 1040) if you itemize deductions. See Publication 529, *Miscellaneous Deductions.*

Licenses and regulatory fees. Licenses and regulatory fees for your trade or business that you pay each year to state or local governments are deductible.

Lobbying expenses. You may deduct expenses you have for appearing before, submitting statements to, or sending communications to the U.S. Congress, its committees, or its individual members, or to any legislative body of a state or political subdivision in connection with legislation or proposed legislation of direct interest to you in carrying on your trade or business. Expenses of communications between you and an organization of which you are a member about such legislative matters of direct interest to you and to the organization may also be deducted.

You also may deduct the part of the dues you pay to an organization of which you are a member that is for the expenses of communicating information between the U.S. Congress, its committees, or its individual members, or to any legislative body of a state or political subdivision in connection with legislation of direct interest to that organization.

You may *not* deduct expenses paid or incurred to influence public opinion on any legislation, election, or referendum. The cost to a corporation of preparing, printing, and distributing a pamphlet to its stockholders urging action on their part to influence legislation is not deductible.

Losses recovered. If you recovered an amount during the tax year to compensate you for unrecovered losses, you may be allowed to take a special deduction. The deduction applies only to damages recovered from patent infringement, breach of contract or fiduciary duty, or antitrust injury that are included in gross income. The deduction for the year is the smaller of:

1) The amount you received or accrued for damages in the tax year reduced by the amount you paid or incurred in the year to recover that amount; or
2) The amount of your losses you had from the injury that you have not yet deducted.

The deduction applies only to recoveries for actual injury and not for any additional amount.

Medical expenses. If an expense is deductible either as a business expense or as a medical expense, you may deduct it as a business expense if:

1) Your work clearly requires that you incur the expense to satisfactorily perform the work; and
2) The goods or services purchased by the expense are clearly not needed or used, other than incidentally, in your personal activities.

Example. Because of a physical handicap, you are confined to a wheelchair. When you must attend out-of-town business and professional meetings you have your spouse, a friend, or a colleague go with you to help you overcome architectual barriers, carry your luggage, and accompany you on transportation that will not accept a wheelchair passenger unless the passenger is accompanied by an attendant. You do not need or use the services of a helper in the conduct of your personal or business activities in your hometown. You pay no salary to any of your helpers, but you do pay for their travel, meals, and lodging when they accompany you on trips.

Because your expenses for your helpers' travel, meals, and lodging are intrinsically part of your expenses paid for travel in connection with carrying on your business and they meet the tests listed above, you may deduct them as business expenses.

Mortgage-dealing expense. If you, as a dealer in mortgages, sell mortgages to the Federal National Mortgage Association (FNMA) and buy FNMA stock as part of the sale, you may not deduct the amount you pay for the FNMA stock as a business expense. You must capitalize the amount, and it becomes your basis in the FNMA stock.

However, if the market value of the stock is lower than the issue price, you may deduct as a business expense the difference between the issue price you pay and the market value on the issue date if you are the first buyer of the FNMA stock. You then must decrease the basis of the FNMA stock by the amount of this deduction.

Marketing fees you pay to the FNMA when you sell mortgages to it are not deductible business expenses. They are treated as selling costs, and you use them to figure your gain or loss on the sales.

Moving machinery. The cost of moving your machinery from one city to another is a deductible expense. So is the cost of moving machinery from one plant to another or from one part of your plant to another part. You may also deduct the cost of installing the machinery in the new location.

Penalties and fines. Penalties you pay for nonperformance of a contract or for late performance are generally deductible. For instance, if you contracted to construct a building by a certain date and had to pay a certain amount for each day the building was not finished after the

date set for completion, you may deduct the amounts paid or incurred.

On the other hand, penalties or fines you pay to any government agency or instrumentality because of a violation of any law are not deductible. These fines or penalties include amounts:

1) Paid because of a conviction for a crime or after a plea of guilty or no contest in a criminal proceeding;
2) Paid as a penalty imposed by federal, state, or local law in a civil action, including additions to tax and additional amounts and assessable penalties imposed by the Internal Revenue Code;
3) Paid as a fine or penalty in settlement of actual or possible liability, whether civil or criminal;
4) Forfeited as collateral posted in connection with a proceeding which could result in the imposition of a fine or penalty.

A few examples of nondeductible penalties and fines are:

1) Fines paid because of violation of city housing codes;
2) Fines paid by truckers because of violation of state maximum highway weight laws and air quality laws;
3) Civil penalties paid because of violation of federal laws regarding discharges into navigable waters and mining safety standards; and
4) Amounts paid to charitable organizations as a condition of probation by a federal district court. These amounts also would not be deductible as charitable contributions.

The amount of a fine or penalty does not include legal fees and related expenses for the defense of a prosecution or civil action for a violation of the law imposing the fine or civil penalty. It does not include court costs or stenographic and printing charges. Compensatory damages (including damages under section 4A of the Clayton Act, as amended) paid to a government are not a fine or penalty.

Political contributions. You may not deduct contributions or gifts you make to political parties or candidates as business expenses. In addition, expenses paid or incurred to take part in any political campaign on behalf of a candidate for public office are not deductible business expenses.

For more information on how individuals may treat certain contributions to candidates for public office, see Publication 585, *Voluntary Tax Methods to Help Finance Political Campaigns.*

Indirect political contributions. You also may not deduct indirect political contributions and costs of taking part in political activities as business expenses. Some examples of these nondeductible kinds of expenses are:

1) Advertising in a convention program of a political party, or in any other publication if any part of the proceeds from the publication is for, or is intended to be for, the use of a political party or candidate;
2) Admission to a dinner or program (including, but not limited to, galas, dances, film presentations, parties, and sporting events) if any part of the proceeds from the function is for, or is intended to be for, the use of a political party or candidate; and
3) Admission to an inaugural ball, gala, parade, concert, or any similar event if it is identified with a political party or candidate.

Recovered expenses. For a discussion on the treatment of reimbursed expenses see *Recovered expenses* in Chapter 1.

Repairs. The cost of repairing, improving or replacing property you use in your trade or business is either a deductible expense or a capital expenditure. What you spend to keep your property in a normal efficient operating condition is a deductible expense. But if what you spend adds to the value of your property or significantly increases its life, the cost must be capitalized. Although capital expenditures cannot be deducted right away, they usually can be deducted over a period of time through depreciation deductions.

Repairs do not add to the value or usefulness of property, nor do they appreciably lengthen its life. They merely maintain the property in an ordinarily efficient operating condition. They do not extend its estimated useful life or change the purpose for which it was acquired. The cost of repairs, including labor, supplies, and certain other items, is a deductible expense. However, the value of your own labor is ***not*** deductible.

Examples of repairs are patching and repairing floors, repainting the inside and outside of a building, repairing roofs and gutters, and mending leaks.

Repair expenses that are allocable to the ***cost of goods sold*** may not be deducted as business expenses.

Repayments. If you included an amount in your income because you thought you had an unrestricted right to it, and in a later year you have to repay all or part of it because it turns out that you did not have an unrestricted right to it, a special rule may apply. Usually, you may deduct the repayment in the year in which you make it. If the income item gave rise to a deduction in the year you included it in income, any deduction for the amount you repay is limited to the net amount you included in income in the prior year.

The character of the deduction in the year of repayment depends on the character of the income you included in the earlier year. For instance, if you repay an amount previously reported as a long-term capital gain, the repayment is deductible as a long-term capital loss.

Example. You use the cash method of accounting. In 1984 you were involved in a lawsuit resulting from a contract dispute with Doe Corporation. The dispute was over how much was owed to you. The court decided in your favor for $2,000. Although Doe Corporation said it would appeal the judgment, it was ordered by the court to pay you immediately without restriction. As promised, Doe Corporation appealed the case and won. The appellate court reversed the lower court's judgment in June 1985. In 1985 you repaid the $2,000 you received in 1984.

You had to include the $2,000 in your income for 1984 because you had an unrestricted right to it. No deduction arose from inclusion. In 1985 you may deduct the $2,000 repayment.

If the amount you repaid was more than $3,000, you should figure your tax two ways:

1) Figure your tax for this year claiming a deduction for the repaid amount.
2) Figure your tax for this year without deducting the repaid amount. Then reduce this tax by the amount your tax in the earlier year was increased because you included in income the amount you later had to repay.

Your tax is the amount in (1) or (2), whichever is less.

If you figure tax for the year of repayment under method (2), the amount repaid may not be deducted in figuring a net operating loss for the year of repayment but is taken into account in figuring the decrease in tax for the prior tax year.

This discussion does not apply if your deduction results from sales of inventory items to customers in the ordinary course of trade or business. It does not apply, therefore, to sales returns and allowances and similar items. Nor does it apply to deductions because of bad debts or to legal fees and other expenses you had in contesting the repayment of income you previously included.

How to account for these repayments. If you use the cash method and you want to claim a deduction in the later year for an item of income that you included in a prior year under a claim of right, you must actually repay the amount. If you constructively received and included in income an amount you never actually received, you may deduct that amount in your tax year in which you are required to give up your right to receive it. If you use any other accounting method, you may deduct the repayment only in the proper tax year under that accounting method.

Supplies and materials. You may deduct the cost of incidential supplies and materials, such as office supplies and wrapping paper, that you use in running your business. However, if you make unusually large purchases of items like these, you may not be allowed to deduct the entire cost in the year you buy them.

You may also deduct the cost of books, professional instruments, equipment, etc., if you normally use them up in less than a year.

Utilities. Almost all businesses have expenses for heat, lights, power, and telephone. These are deductible expenses. However, only the part of your utilities expense that is for business use may be deducted. Any part that is due to personal use is not deductible.

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